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COMPANY LAW

Third Edition

Lee Roach

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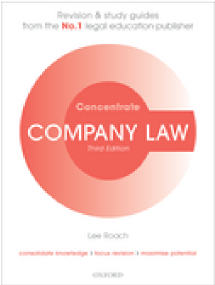

Company Law Concentrate: Law Revision and Study Guide (3rd edn)

Lee Roach

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Dedication

(p. ii) To Tom and Sandra Roach

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New to this edition

- Coverage of the establishment of the Financial Conduct Authority.
- Updated coverage of developments aimed at increasing gender diversity in the boardroom.
- Updated coverage on the law relating to the duties owed by shadow directors.
- Coverage of the new duty placed upon directors to prepare a strategic report.
- Updated coverage of the provisions introduced by the Enterprise and Regulatory Reform Act 2013 in relation to directors' remuneration.
- Discussion of the new system by which charges are registered.
- Updated coverage of case law relating to permission to continue a derivative claim.
- Notable case law developments include:
    - **a)** *GHLM Trading Ltd v Maroo* [2013] (duty to disclose breaches of duty)
    - **b)** *Petrodel Resources Ltd v Prest* [2013] (piercing the corporate veil)
    - **c)** *VTB Capital plc v Nutritek International Corp plc* [2013] (piercing the corporate veil)
    - **d)** *Vivendi SA v Richards* [2013] (duties owed by a shadow director)

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Preface

Company Law Concentrate has two clear aims. First, it aims to provide a clear and succinct guide to help you better understand a number of prominent and regularly assessed company law topics. Second, it offers a number of useful hints and tips to aid you in revising for, and sitting, a company law exam. *Company Law Concentrate* does not aim to provide an overview of an entire company law syllabus, nor could it do so without being appreciably lengthier. Nor does it aim to provide the level of detail and analysis that a good textbook should provide. In other words, *Company Law Concentrate* cannot and does not seek to replace the knowledge you will gain from a high-quality textbook. Instead *Company Law Concentrate* aims to complement your existing textbook. Company law texts can often be complex, technical, and difficult to understand. Further, company law texts are required to cover a broad syllabus without necessarily indicating which topics are assessed most regularly. *Company Law Concentrate* aims to address both of these issues by covering those topics that tend to arise in exams in a simple and easy to understand manner, and to provide you with clear guidance on how best to discuss these topics whilst avoiding common mistakes and pitfalls. Having said that, students should not assume that the topics discussed within are guaranteed to arise in an exam, and the content of company law courses does vary substantially—for example, some company law courses might not discuss the various rescue and insolvency procedures discussed in chapter 10.

It is hoped that *Company Law Concentrate*, alongside your existing textbook, will provide you with the foundation you need to effectively revise for, and obtain a high mark in, your company law exam. Bear in mind, however, that high marks come from the sort of critical analysis that is usually not found in textbooks, but is found in journal articles and other specialist academic works. Accordingly, reference will be made to useful articles that you might wish to consider reading.

Despite the relatively short period of time between the second edition of *Company Law Concentrate* and this edition, significant legal developments have still taken place and so this edition has been thoroughly revised to provide an up-

to-date account of company law. The law will continue to evolve, however, and, to help you remain on top of legal developments, the book is accompanied by a Twitter account (@UKCompanyLaw), which will provide details of relevant legal developments.

I offer my thanks to the publishing team at OUP for their hard work. In particular, I would like to thank Tom Randall, Sarah Stephenson, and Deborah Renshaw whose encouragement and aid were of enormous help. I would also like to thank the anonymous reviewers whose insightful comments were of great benefit.

I have attempted to state the law as at April 2014.

*Portsmouth, April 2014*LRR

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List of abbreviations

The following is a list of abbreviations used in this text.

AGM
annual general meeting
CA 1985
Companies Act 1985
CA 2006
Companies Act 2006
CDDA 1986
Company Directors Disqualification Act 1986
CVA
company voluntary arrangement
FCA
Financial Conduct Authority
FSA
Financial Services Authority
IA 1986
Insolvency Act 1986
LLP
limited liability partnership
LLPA 2000
Limited Liability Partnerships Act 2000
NED

non-executive director
PA 1890
Partnership Act 1890

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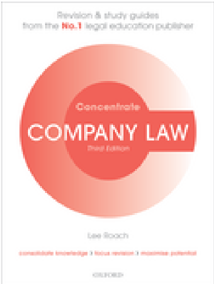

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Law Trove

Company Law Concentrate: Law Revision and Study Guide (3rd edn)

Lee Roach

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1. Business structures

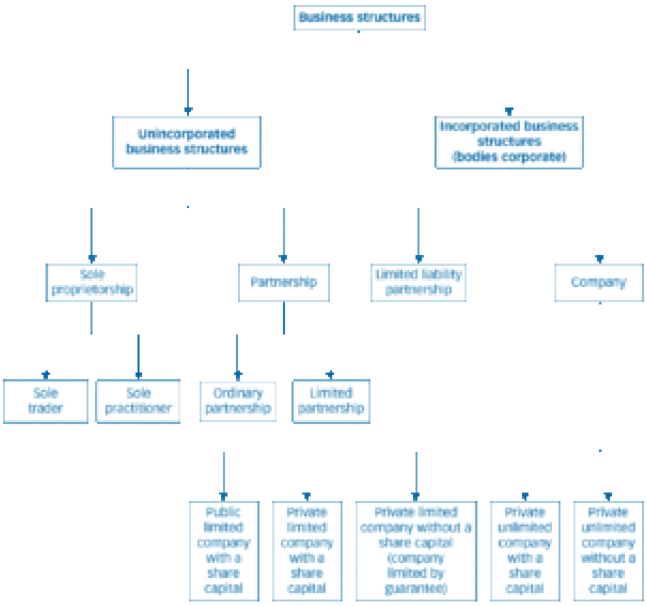
Chapter: (p. 1) 1. Business structures
Author(s): Lee Roach
DOI: 10.1093/he/9780198703808.003.0011

Key facts

- The four principal business structures are the sole proprietorship, the partnership, the limited liability partnership, and the company.
- Sole proprietorships are the most common business structure and involve little formality, but the liability of the sole proprietor is personal and unlimited.
- Two or more persons who wish to conduct business can form an ordinary partnership. Such partnerships are subject to greater regulation than sole proprietorships, but less regulation than limited liability partnerships and companies. The liability of the partners is personal and unlimited.
- Limited liability partnerships were created largely to be a suitable business vehicle for large professional firms. In many respects, limited liability partnerships closely resemble companies.
- Public companies are so called because they can offer to sell their shares to the public at large. Private companies cannot offer to sell their shares to the public at large. There are other notable differences between public and private companies.
- The vast majority of companies are limited companies, and so their members will usually have limited

liability.

(p. 2) Chapter overview



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(p. 3) Introduction

A person who wishes to engage in some form of business activity will need to do so via some form of business structure, with differing business structures providing different advantages and disadvantages. In the UK, four principal business structures can be identified, namely:

1. the sole proprietorship
2. the ordinary partnership
3. the limited liability partnership (LLP), and
4. the company.

Two of these business structures (the LLP and the company) are created via a process called incorporation and are therefore known as incorporated business structures or, as they are referred to in their respective statutes, as ‘bodies corporate’. The other two structures (namely, the sole proprietorship and the ordinary partnership) are not created via incorporation (although the Law Commission has recommended that ordinary partnerships should have corporate personality) and so are known as unincorporated business structures.

Revision tip

Although company law focuses on the regulation of companies, it is important that you understand the advantages and disadvantages that companies have when compared to other business structures. Indeed, an essay question may require you to discuss such advantages and disadvantages. Alternatively, a problem question may provide you with a set of facts involving the setting up of a new business, and you might have to advise which business structure would be most suitable for the new business.

Sole proprietorship

The simplest and most popular business structure is the sole proprietorship. A sole proprietor is simply a single natural person carrying on some form of business activity on his own account. Whilst a sole proprietorship will be carried on by an individual for that individual's benefit, sole proprietors can take on employees, although the vast majority do not. The key point is that the sole proprietorship is not incorporated, nor does the sole proprietor carry on business in partnership with anyone else.

Sole proprietorships come in two forms:

1. Where the sole proprietor is a professional (e.g. solicitor, accountant), he will be known as a 'sole practitioner'.
2. Where the sole proprietor is not a professional, he will be known as a 'sole trader'. Although it is common to refer to all unincorporated single person businesses as sole traders, a sole practitioner is not in fact a sole trader.

(p. 4) Unlike incorporated structures, there is no separation between a sole proprietor and his business, and sole proprietorships do not have corporate personality (discussed at p 31 'Corporate personality'). Accordingly, the sole proprietor owns all of the assets of the business and is entitled to all the profit that the business generates.

Formation and regulation

Commencing business as a sole proprietor is extremely straightforward and involves much less formality than creating a LLP or company. All that an individual need do to commence business as a sole proprietor is register himself with HM Revenue & Customs as self-employed. Sole proprietorships are not generally subject to the **Companies Act 2006 (CA 2006)**, so do not need to file accounts at Companies House and are subject to much less regulation than companies. However, being self-employed, sole proprietors are required to complete their own tax returns, so sole proprietors should maintain clear and accurate records of all transactions entered into.

Finance

In terms of raising finance, sole proprietorships are at a disadvantage when compared to other business structures. Partnerships can raise finance by admitting new partners. Companies, especially public companies, can raise finance by selling shares. Neither of these options is available to a sole proprietor who wishes to remain a sole proprietor. A sole proprietor will either need to invest his own money into the business (and risk losing it should the business fail) or obtain a loan. Given that many sole proprietorships are small affairs, banks are cautious when lending to sole proprietors and obtaining large amounts of debt capital is usually impossible.

Liability

The principal disadvantage of carrying on business as a sole proprietorship is that the liability of the sole proprietor is personal and unlimited. Whereas partnerships and companies can be limited, it is impossible to create a limited sole proprietorship. Accordingly, the sole proprietor's assets (including personal assets such as his house, car and bank accounts) can be seized and sold in order to satisfy the debts and liabilities of the sole proprietorship. If the sole proprietorship's debts/liabilities exceed the assets of the sole proprietor, he will likely be declared bankrupt.

Partnership

Two or more persons who wish to carry on business together cannot do so as a sole proprietorship for obvious reasons. For such persons, a partnership may be a more appropriate business structure, of which there are three different forms:

1. the ordinary partnership (usually referred to simply as a 'partnership'), on which this section will focus;
(p. 5) 2. the limited partnership, which is a form of partnership that can be formed under the **Limited Partnerships Act 1907**. Limited partnerships are extremely rare and need not be discussed further here;

3. the limited liability partnership which, being an incorporated business structure, is discussed later at p 6, 'Limited liability partnership'.

Section 1(1) of the Partnership Act 1890 (PA 1890) defines a partnership as 'the relation which subsists between persons carrying on a business in common with a view to profit'.

> Looking for extra marks?
>
> This seemingly simple definition contains a number of notable words and phrases that have proven difficult to define clearly in practice. For a more detailed discussion of the definition found in **s 1(1)**, see Geoffrey Morse, *Partnership Law* (7th edn, OUP 2010) 14–28.

The relationship between the partners

The **PA 1890** lays down detailed rules regarding the relationship between the partners. Many partnerships will have in place a written partnership agreement that sets out the rights and obligations of the partners. Where a partnership agreement does not exist, **ss 24 and 25 of the PA 1890** imply a number of default terms that will apply to the partnership. In fact, these implied terms will apply even where a written partnership agreement does exist, unless the implied terms are inconsistent with, or are excluded by, the terms of the written agreement. Examples of these implied terms include:

- All of the partners are entitled to share equally in the profits of the firm and must also contribute equally towards the firm's losses.
- Every partner may take part in the management of the firm.
- No new partners may be admitted to the firm without the consent of all the other partners.
- The agreement between the partners can only be altered with the express consent of all the partners.
- The majority of the partners cannot expel a partner unless an express power to do so has been agreed upon by all the partners.

The relationship between partners and third parties

Sections 5–18 of the PA 1890 regulate the relationship between the partners and third parties. This includes the extent to which the partners can contractually bind the firm and the other partners to a third party, and the extent to which the firm and the other partners can be liable for the acts or omissions of a single partner that cause a third party to sustain loss.

(p. 6) Agency

Regarding a partner's ability to bind his partnership and co-partners to a third party, the key provision is **s 5 of the PA 1890**, which provides that each partner is an agent of the firm and of his co-partners. Accordingly, providing a partner acts within his authority, he is able to contractually bind his firm and his co-partners to a third party. In fact, in certain cases, a binding contract may exist where the partner has exceeded his authority, or even where he has no authority. As each partner has the power to contractually bind his co-partners, it follows that every partner is jointly liable for the debts and obligations of the firm incurred while he is a partner. As with a sole proprietorship, the liability of the partners is personal and unlimited.

Liability for tortious and other wrongful acts

Partners may be held liable in tort or found guilty for the criminal acts of other partners. **Section 10 of the PA 1890** provides that the partnership and each partner is vicariously liable for the wrongful acts or omissions of another partner, providing that the partner was acting within his authority, or that the act or omission was done whilst in the

ordinary course of the firm’s business.

Example

Coffey & Sons is a UK-based firm of accountants consisting of 50 partners. One of the firm’s partners, Kirsty, is conducting an audit of BioTech plc, but she conducts the audit negligently. Under **s 10**, Coffey & Sons and the other 49 partners face liability for Kirsty’s act of negligence.

Liability under **s 10** is joint and several, meaning that the claimant can sue each partner in turn, or all the partners at the same time, until he has recovered the full amount of his loss. Liability is both personal and unlimited.

Limited liability partnership

With the passing of the **Limited Liability Partnerships Act 2000 (LLPA 2000)**, two or more persons can now form a limited liability partnership **(LLP)**.

Revision tip

Students often confuse limited liability partnerships with limited partnerships, but the two business structures are very different. A LLP is a body corporate created under the **LLPA 2000**, whereas a limited partnership is merely a specialized (and extremely rare) type of partnership that can be created under the **Limited Partnerships Act 1907**. Although both offer limited liability, the limitations placed upon the limited partners of a limited partnership (notably the inability to take part in management) make LLPs a much more attractive option.

In order to understand the purpose and functions of LLPs, it is vital to understand why the **LLPA 2000** was enacted. For large professional firms (e.g. accountants and solicitors) who may have thousands of partners worldwide, the joint and several liability of the partners (p. 7) meant that, for example, one partner in London could be personally liable for the unlawful acts of a New York-based partner that he had never met. The largest accountancy firms therefore lobbied the UK government to create a new form of partnership that provided its partners with limited liability similar to that enjoyed by the members of limited companies. The result was the **LLPA 2000**.

Revision tip

An essay question in this area might require you to discuss the LLP and the extent of its usefulness. The story of the passing of the **LLPA 2000** is significant as it is only professional firms that have expressed a significant interest in adopting LLP status. It is not therefore a business structure of widespread use and it is certainly not a structure designed to cater to the needs of small businesses. This is demonstrated in that, as of March 2014, there were only 59,327 LLPs incorporated in the UK.

Some argue that LLPs are hybrid organizations that combine the characteristics of a partnership and a company. Whilst this is true, there is little doubt that LLPs have more in common with registered companies than with partnerships:

- Like a registered company, a LLP is created by registering documents with the Registrar of Companies at Companies House.

- Like a registered company, a LLP is a body corporate (**LLPA 2000, s 1(2)**) and therefore has corporate personality (discussed at p 31, 'Corporate personality').
- The **LLPA 2000** refers to the partners of a LLP as 'members'.
- The members of a LLP, like the members of most registered companies, will have limited liability.
- Generally, LLPs are regulated by company law, although there are notable areas in which they are regulated by partnership law. Many provisions of the **CA 2006** and virtually all the provisions of the **Insolvency Act 1986** will therefore apply to LLPs as well as companies.

Liability

In the event of a partnership being dissolved, the partners are liable for the debts of the firm, with such liability being personal and unlimited. Conversely, the members of a LLP need contribute nothing when it is wound up, although there are several exceptions to this (e.g. the members of a LLP can be found liable for wrongful trading—discussed at p 167, 'Wrongful trading'). Accordingly, the LLP remedies the principal weakness of the partnership, namely the personal and unlimited liability of its partners. As the LLP has corporate personality, it follows that the LLP itself will be liable for its debts and can be vicariously liable for the acts of its members, agents, and employees.

It should also be noted that a member of a LLP can be disqualified from acting as a member of a LLP or as a company director under the **Company Directors Disqualification Act 1986**.

Table 1.1 summarizes the principal differences between an ordinary partnership and a LLP.

Table 1.1 The differences between an ordinary partnership and a LLP

	Ordinary partnership	**LLP**
Formation?	Can be formed informally by two or more persons agreeing to carry on business in partnership	Formally incorporated by registering certain documents with the Registrar of Companies
Has corporate personality?	No	Yes
Regulated by?	Regulated by partnership law, notably the **PA 1890**	Regulated by company law, unless the **LLPA 2000** states otherwise
Partners known as?	The partners of an ordinary partnership are simply known as 'partners'	The partners of a LLP are known as 'members'
Liability of partners?	The partners of an ordinary partnership are jointly liable for the debts of the partnership and are jointly and severally liable for its liabilities	The members of a LLP are not generally liable for the debts and liabilities of a LLP—the LLP itself will be liable
Disqualification?	The partners of an ordinary partnership cannot be disqualified from acting as a partner of an ordinary partnership	The members of a LLP can be disqualified from acting as a member of a LLP (or as a company director)

(p. 8) Company

The processes by which a company can be created and the advantages and disadvantages of conducting business

through a company are fundamental issues and are therefore discussed more fully in chapter 3. Here, the discussion will focus on the different forms of company that can be created. The **CA 2006** provides for a number of different forms of company that are classifiable by reference to certain characteristics, namely:

1. Is the company to be public or private?
2. Is the liability of the company's members to be limited or unlimited? If liability is to be unlimited, then the company must be private—the law does not allow for the creation of unlimited public companies.
3. Does the company have a share capital or not? Public companies must have a share capital, but private companies need not, although the vast majority do (in 2012–13, 482,800 new companies were incorporated in the UK, of which only 16,400 did not have a share capital). A limited company that does not have a share capital will be (p. 9) known as a company 'limited by guarantee,' although it is possible for a company limited by guarantee to still have a share capital if the company was created before 22 December 1980.

As companies limited by share capital vastly outnumber companies limited by guarantee, this book (and indeed most company law courses) will focus primarily on companies with a share capital. As the focus is on companies limited by shares, it is the first two characteristics mentioned above that are of crucial importance, beginning with the differences between public and private companies.

Public and private companies

When creating a company, the promoters are required to state whether the company is to be registered as a private company or as a public company. A public company is a company limited by shares, or limited by guarantee and having a share capital, whose certificate of incorporation states that it is a public company (**CA 2006, s 4(2)**). A private company is simply defined as any company that is not a public company (**CA 2006, s 4(1)**).

The principal differences between a public company and a private company include:

1. A public company is so called because it may offer to sell its shares to the public at large and, to facilitate this end, it may list its shares on a stock market (such companies are known as **listed companies or quoted companies** and are discussed later), with the principal market in the UK being the London Stock Exchange. This allows public companies to raise massive amounts of capital very quickly (for example, Facebook's initial public offering on NASDAQ allowed it to raise over $16 billion in one day through the selling of shares). Private companies are not permitted to offer to sell their shares to the public at large (**CA 2006, s 755(1)**), nor can they list their shares on a stock exchange (**Financial Services and Markets Act 2000, s 74**). As a result, private companies can often find it difficult to obtain sufficient levels of capital.
2. Whilst private companies can be created with a trivial amount of capital (e.g. a single 1 pence share), public companies are required to have an allotted share capital of at least £50,000 (this requirement is discussed in more detail at p 123, 'Minimum capital requirement').
3. Both private and public companies can be created with only one member. However, whereas a private company can be formed with only one director, a public company must have at least two directors (**CA 2006, s 154**).
4. Public companies are required by law to appoint a company secretary **(CA 2006, s 271)**, whereas private companies are not (but may do so if they wish).
5. Private limited companies are required to add the suffix 'Ltd' following their name (**CA 2006, s 59(1)**). Public companies must add the suffix 'plc' (**CA 2006, s 58(1)**).

Table 1.2 summarizes the differences between public and private companies.

Table 1.2 The differences between a public company and a private company

	Public	**Private**
Number of companies?	As of March 2014, there were 7,831 public companies registered in the UK (0.3% of the total number of companies)	As of March 2014, there were 3,214,959 private companies registered in the UK

		registered in the UK (99.7% of the total number of companies)
Required to have a share capital?	Yes	No, but the vast majority of private companies do have a share capital
Limited or unlimited liability of members?	Public companies must be limited. It is impossible to create an unlimited public company	Can be limited or unlimited, although the vast majority are limited
Can offer to sell shares to the public at large?	Yes	No
Can list shares on a stock exchange?	Yes, although the majority of public companies do not list their shares	No
Minimum capital requirement?	£50,000	Can be created with a nominal amount of capital
Minimum number of directors?	Two	One
Suffix?	plc	Ltd
Required to appoint a company secretary?	Yes, public companies must appoint a company secretary	No, but may do so if it chooses
Level of regulation?	The **CA 2006** regulates public companies more stringently than private companies. Quoted companies are regulated even more stringently by having to comply with **Pt VI of the Financial Services and Markets Act 2000** and the **Listing Rules**, and having to comply or explain against the recommendations in the **UK Corporate Governance Code**	

(p. 10) Revision tip

It is vital that you are aware of the differences between public and private companies as the **CA 2006** regulates

public companies more heavily than private companies. In problem questions, distinguishing between public and private companies will usually be straightforward due to the requirement to state Ltd or plc after the company's name. Certain public companies are regulated even more strictly by additional rules contained in the **Listing Rules**.

(p. 11) The Listing Regime and the UK Corporate Governance Code

As noted, public companies are able to list their shares on a stock market, and such companies are known as listed companies or quoted companies.

Revision tip

It is worth noting that the **CA 2006** never uses the term 'listed company', but instead refers to 'quoted companies'. Under **s 385(2)**, a quoted company includes not only companies whose shares are listed on the UK official list, but will also include companies whose shares are listed in an EEA state, or are listed on the New York Stock Exchange or Nasdaq.

It is worth noting that most public companies are not listed—as of March 2014, there were 7,831 public companies in the UK, of which only 2,442 were listed. In addition to having to comply with the **CA 2006**, listed companies are also required to comply with the provisions of **Pt VI of the Financial Services and Markets Act 2000** and a body of rules collectively known as the Listing Regime, which principally comprises of (i) the **Disclosure and Transparency Rules**, (ii) the **Prospectus Rules**, and, most importantly, (iii) the **Listing Rules**. The **Listing Rules** are drafted, administered, and updated by the Financial Conduct Authority (FCA) and impose obligations upon listed companies in relation to the disclosure of information, as well as supplementing the **CA 2006** as regards certain areas of internal control. The FCA is regarded as the 'competent authority' under **Pt VI of the Financial Services and Markets Act 2000**, meaning that the **Listing Rules** effectively have the force of law.

Looking for extra marks?

The FCA was established in April 2013 following the coming into force of the **Financial Services Act 2012**. The FCA replaces in part the now abolished Financial Services Authority (FSA), which was abolished following failures in relation to its conduct during the financial crisis of 2007–8. Ensure you are aware of why the FSA was abolished and the role and effectiveness of the FCA. For more on the role of the FCA, see www.fca.org.uk.

The **Listing Rules** also state that all listed companies should comply with the **UK Corporate Governance Code**, or explain why they have not complied with the Code. This Code is discussed in more detail at p 100, 'The UK Corporate Governance Code', where the UK system of corporate governance is discussed.

Revision tip

Students are often aware of the provisions of the **CA 2006**, but often neglect to discuss the rules laid down by the **Listing Rules** and the recommendations found within the **UK Corporate Governance Code**. As the **Listing Rules** effectively have the force of law and as the **Listing Rules** state that listed companies should comply with the **UK Corporate Governance Code**, or to explain why they have not complied with the Code, it is vital that you are aware of these rules and recommendations should you have to answer a problem question concerning a listed company.

(p. 12) **Limited and unlimited companies**

The terms 'limited' and 'unlimited' do not actually refer to the company itself, but to the liability of its members. As noted, the liability of the members of a public company must be limited (**CA 2006, s 4(2)**). Where the promoters decide to form a private company, they will need to decide whether the liability of the company's members will be limited or unlimited.

Limited

The vast majority of companies are limited companies. In 2012–13, there were around 2.8 million companies registered in the UK, of which only 4,800 were unlimited companies. Where the liability of a company's members is limited, the form and extent of the limitation will depend upon whether their liability is limited by guarantee or by shares:

- Where a company is limited by guarantee, the liability of the members is limited to the amount stated in the statement of guarantee (**Insolvency Act 1986, s 74(3)**).
- Where a company is limited by shares, the liability of the company's members will usually be limited to the amount that is unpaid on their shares (**Insolvency Act 1986, s 74(2)(d)**). Members who have fully paid for their shares are generally not liable to contribute any more to the company. The vast majority of limited companies are limited by shares, and so the following example will demonstrate the operation of limited liability in a company limited by shares.

Example

A newly incorporated company, Spartan plc, issues 100,000 shares, and provides that subscribers can pay fully for their shares immediately, or can pay half now and the remainder at a later date. The shares have a nominal value of £1 (the nominal value of a share is discussed at p 117, 'Nominal value'). Tom decides to buy 1,000 shares and takes advantage of the ability to pay half the amount. He therefore pays £500. A few months later, before Tom has paid the remaining amount, Spartan enters liquidation. The liquidator will be able to recover from Tom the remaining £500 (i.e. Tom's liability is limited to £500). Had Tom paid the full £1,000 prior to liquidation, then the liquidator would not have been able to recover any more money from Tom.

As this example demonstrates, limited liability remedies the principal weakness of sole proprietorships and ordinary partnerships, namely personal and unlimited liability.

Unlimited

Only 0.2 per cent of all companies are unlimited. The reason why there are so few unlimited companies is simple: in an unlimited company, upon winding up, the liability of the members is personal and unlimited, so their personal assets (e.g. house, car, bank accounts etc.) can be seized and sold to satisfy the company's debts.

(p. 13) #### Looking for extra marks?

The obvious question is why would a company choose unlimited liability and you should be prepared to answer this question. The principal answer is that unlimited companies are subject to less regulation than limited companies. For example, unlimited companies do not generally need to file their accounts with the Registrar of Companies (**CA 2006, s 448(1)**), so their affairs can be conducted with more privacy and with less formality. However, such concessions are unlikely to be a fair trade-off for the loss of limited liability.

Key debates

Topic	**The limited liability partnership**
Author/Academic	Stuart R Cross
Viewpoint	Discusses the operation and background of the **LLPA 2000** and highlights a number of problem areas that are likely to impede the usefulness of LLPs.
Source	'Limited Liability Partnerships Act 2000: Problems Ahead' [2003] JBL 268
Topic	**Forms of company**
Author/Academic	Andrew Hicks, Robert Drury and Jeff Smallcombe
Viewpoint	Argues that the private limited company is not a suitable business structure for many small businesses. Argues that the regulation that small businesses wish to avoid is a consequence of limited liability, and so a new company form should be made available which does not offer its members limited liability, and is regulated by partnership law.
Source	*Alternative Company Structures for the Small Business* (Association of Certified Chartered Accountants 1995)

Exam questions

Essay question

> 'The limited liability partnership is an ideal business structure for small businesses as it combines the best features of a partnership and a company.'

Do you agree with the above statement? Provide reasons for your answer.

See the Outline answers section in the end matter for help with this question.

(p. 14) Problem question

Dean is a successful sole practitioner offering business consultancy services to a number of local companies. His chief competitor is Caroline, who offers similar services. Caroline and Dean decide that they wish to work together, but are unsure as to which business structure would be most appropriate. They seek your advice regarding which business structure would be most suitable, bearing in mind:

- they wish to avoid significant levels of formality and regulation

- they want to have flexibility in establishing the procedures by which the business is to be run
- they want to be able to run their affairs in private
- they want to avoid personal liability for the debts and liabilities of the business
- the process of creating the business should be relatively cheap and quick
- they do not want to invest significant amounts of their own capital in setting up the business and will probably wish to raise capital from outside sources
- they wish to take on employees.

Discuss to what extent the various business structures fulfil all, or some, of these aims and advise Dean and Caroline which business structure would be most suitable for their business.

Online Resource Centre

To see an outline answer to this question log on to www.oxfordtextbooks.co.uk/orc/concentrate/

Law Trove

Company Law Concentrate: Law Revision and Study Guide (3rd edn)

Lee Roach

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2. Promotion of the company

Chapter: (p. 15) 2. Promotion of the company
Author(s): Lee Roach
DOI: 10.1093/he/9780198703808.003.0046

Key facts

- Certain persons who are involved in the formation of a company are known as ‘promoters’.
- A promoter owes fiduciary and statutory duties to the unformed company, notably a promoter cannot make a secret profit out of the company’s promotion.
- A promoter will usually be personally liable on a contract entered into on behalf of a company if that company has not been incorporated at the time the contract was entered into.

(p. 16) Introduction

Company law is not solely concerned with what happens once a company has been created as legal questions and disputes can arise prior to a company’s creation. This chapter looks at the legal position of persons in the process of incorporating a company, and the legal relationship that exists between them and the unformed company, and with any third parties who contract with the promoters or the company prior to it being incorporated.

Promotion of the company

Persons who wish to create a company may need to undertake various activities in order for the company to be able to commence business (e.g. preparing incorporation documents, hiring or buying premises, obtaining supplies or operating capital). Such persons, who usually go on to become the company's first directors, are known as 'promoters' of the company and their activities are closely regulated by the law.

When will a person be a promoter?

The law has not sought to define precisely what a promoter is. If it did, persons would try to take themselves out of the definition in order to avoid regulation. However, the lack of a definition can be problematic, as determining whether or not a person is a promoter is crucial for several reasons:

- promoters owe fiduciary duties to the unformed company
- promoters can be made liable for acts engaged in on behalf of the unformed company, and
- the **CA 2006** imposes a number of obligations on company promoters, especially promoters of public companies.

Accordingly, the courts have offered guidance as to who is a promoter, with the classic statement being that of Bowen J in ***Whaley Bridge Calico Printing Co v Green* (1880)**:

> The term promoter is a term not of law, but of business, usefully summing up in a single word a number of business operations familiar to the commercial world by which a company is generally brought into existence.

Accordingly, the word promoter is a general word that refers to those persons involved in the formation of a company based upon the particular facts of the case. However, not all persons involved in the company's formation will be categorized as promoters. For example, persons involved in the formation of a company by virtue of their professional duties (e.g. solicitors or accountants who provide the promoters with advice) will not be regarded as promoters (***Re Great Wheal Polgooth Co Ltd* (1883)**).

(p. 17) Looking for extra marks?

In problem questions concerning the promotion of the company, students often forget to discuss whether the persons concerned are promoters, usually because they feel the issue is obvious. Even where a person is clearly a promoter, you should establish this with reference to authority. For a discussion of the authority relating to the identification of promoters, see Joseph H Gross, 'Who is a Company Promoter?' (1970) 86 LQR 493.

Duties of a promoter

A promoter occupies a dominant position in relation to the unformed company and, to prevent that position being abused, the promoter will owe the unformed company a number of duties. Two broad categories of duty can be identified, namely the fiduciary duty and duties imposed by statute.

Fiduciary duty

A promoter occupies a fiduciary position in relation to the unformed company. Accordingly, he is not permitted to make a profit out of the company's promotion, unless he discloses the nature of his interest and the profit made. Should he fail to disclose the profit, the transaction in question will be voidable and so can be rescinded by the company (***Erlanger v New Sombrero Phosphate Co* (1878)**). If rescission fails to recover the value of the profit or if

the right to rescind is lost, then the promoter can be made to account to the company for the value of the profit (***Emma Silver Mining Co v Grant* (1879)**). So, for example, if upon incorporation, a promoter sells to the newly formed company an asset that he acquired during the company's promotion, he will not be permitted to keep the proceeds of the sale, unless he discloses the nature of the interest and the extent of the profit made. However, disclosure will only be valid if the persons to whom it is made are independent, as the following case demonstrates.

Erlanger v New Sombrero Phosphate Co (1878) LR 3 App Cas 1218 (HL)

FACTS:

Erlanger headed a syndicate that, for £55,000, acquired a lease to certain mining rights. The syndicate set up a company to take advantage of the mining rights. Five directors were appointed, but two were abroad, one was the Lord Mayor of London (and so could devote little time to the company), and the remaining two had strong links to Erlanger. Through one of the directors with links to Erlanger, the lease was sold to the company for £110,000. Full details of the transaction were not disclosed to the company's members.

HELD:

The contract for the sale of the lease was voidable at the company's instance. The directors may have known the details of the transaction, but this disclosure was insufficient as the key directors were mere puppets who, according to Lord Blackburn, had not given the transaction the **(p. 18)** 'intelligent judgment of an independent executive'. The company therefore rescinded the lease, and recovered the £110,000 paid.

Accordingly, in order for disclosure to be valid, there must be an independent board of directors or an independent body of members to hear the disclosure and, if necessary, to act upon it.

Statutory duties

In addition to the common law fiduciary duty, promoters are also subject to statutory duties. For example, **s 598 of the CA 2006** states that a non-cash asset cannot be sold to a public company by a person who is a subscriber to the company's memorandum, unless the non-cash asset has been independently valued, and the members have approved the sale.

Pre-incorporation contracts

Prior to incorporation being completed, the promoters of the unformed company will likely need to enter into contractual agreements with third parties in order to cater for the company's future needs. The promoters may need to contract with creditors to obtain capital, or they may need to contract for supplies or office premises, or take on employees. A company has the capacity to enter into contracts with such persons, but not until it is fully incorporated (see p 53, 'The capacity of a company'). If the promoters attempt to contract on behalf of, or in the name of, the unformed company, are such pre-incorporation contracts invalid, or because they are to benefit the unformed company, will they be regarded as valid?

Common law

Prior to the UK joining the European Economic Community (now the European Union (EU)), the answer was to be found in case law, but it was based on determining the intent of the parties, as revealed in the contract (***Phonogram Ltd v Lane* [1982]**)—a process which proved to be notoriously difficult and which resulted in significant confusion in the law and a perception that cases in this area could turn based on complex and technical distinctions.

Revision tip

For an example of the distinctions drawn, contrast the cases of ***Kelner v Baxter* (1866)** and ***Newborne v Sensolid (Great Britain) Ltd* [1954]**. In ***Kelner***, the promoter signed the contract 'on behalf of' the unformed company, and it was held that a binding contract existed between the promoter and the third party. In ***Newborne***, the promoter signed the contract using the company's name and added his own signature underneath. It was held that the contract was between the promoter and the unformed company and, as the company had no contractual capacity, no contract existed.

(p. 19) **Statute**

As a consequence of the UK's entry into the EU, it was obliged to implement the **First EC Company Law Directive**, of which **Art 7** states:

> If, before a company has acquired legal personality ... action has been carried out in its name and the company does not assume the obligations arising from such action, the persons who acted shall, without limit, be jointly and severally liable therefore, unless otherwise agreed.

Article 7 has been implemented by **s 51(1) of the CA 2006**, which states:

> A contract that purports to be made by or on behalf of a company at a time when the company has not been formed has effect, subject to any agreement to the contrary, as one made with the person purporting to act for the company or as agent for it, and he is personally liable on the contract accordingly.

The basic effect of **Art 7** and **s 51** is to render a promoter personally liable for the pre-incorporation contract in all cases to which **s 51** applies. This clearly benefits third parties who contract with the promoter, as they will be able to sue the promoter should the terms of the pre-incorporation contract be breached.

Looking for extra marks?

Section 51 makes it clear that a promoter will be personally liable for the pre-incorporation contract, but does not indicate whether or not the third party can be liable to the promoter in the event of the third party failing to honour the contract. In ***Braymist Ltd v Wise Finance Co Ltd* [2002]**, it was held that a promoter could sue a third party, but the fact that judicial clarification was required demonstrates a flaw in the drafting of **s 51** that you might wish to bring up in a possible essay question on the effectiveness of **s 51**.

The courts have clearly stated that a company, once incorporated, cannot ratify or adopt a pre-incorporation contract made on its behalf (***Re Northumberland Avenue Hotel Co* (1886)**). The only way that a company can take advantage of a pre-incorporation contract is for the promoter and third party to discharge the pre-incorporation contract and the company then to enter into a new contract with the third party in respect of the same subject matter (***Howard v Patent Ivory Manufacturing Co* (1888)**). This process of substituting one contract with another is known as 'novation'.

Looking for extra marks?

Students paying careful attention to **Art 7** will note that it permits companies to 'assume the obligations' of the pre-incorporation contract, whereas **s 51** does not. It could accordingly be argued that **s 51** does not fully implement **Art 7**, and that the failure to allow companies to assume the contract is an unnecessary restriction. Companies who wish to assume the obligations of the contract will need to undergo the discharge procedure

previously discussed, which will likely be (p. 20) viewed as an undue waste of time and effort. On this, see Robert R Pennington, 'The Validation of Pre-Incorporation Contracts' (2002) 23 Co Law 284, who argues that English law should allow companies to adopt pre-incorporation contracts.

Where the promoters enter into a contract before purchasing an 'off the shelf' company (discussed at p 26, '"Off-the-shelf" companies'), then, providing that the company existed at the time the contract was entered into, **s 51** will not apply as the company is not one that 'has not been formed' and a valid contract will exist between the company and the third party. The same principle applies where a company changes its name, but the name change has not been registered at the time the contract is made (***Oshkosh B'Gosh Inc v Dan Marbel Inc Ltd* [1989]**). Similarly, **s 51** will not apply where a person contracts on behalf of a company that previously existed, but no longer exists at the time the contract was entered into (***Cotronic (UK) Ltd v Dezonie* [1991]**).

'Subject to any agreement to the contrary'

The imposition of liability under **s 51** is 'subject to any agreement to the contrary', which means that a promoter can avoid liability if he can show that he and the other party to the contract agreed that, upon incorporation, the promoter would be released from liability and the company would enter into a second contract with the other party on the same terms as the first contract (i.e. an agreement to novate the contract was present). The agreement can be express or implied, but the courts will require clear evidence that such an agreement exists (***Bagot Pneumatic Tyre Co v Clipper Pneumatic Tyre Co* [1902]**). In the absence of an express agreement, this will likely be difficult for a promoter to prove. Simply acting as a promoter or agent of a unformed company will not be enough to infer the existence of a contrary agreement (***Phonogram Ltd v Lane* [1982]**).

Key cases

Case	Facts	Principle
***Erlanger v New Sombrero Phosphate Co* (1878)** LR 3 App Cas 1218 (HL)	The promoters of a company sold the company a lease. The details of the transaction were disclosed to the company's directors, but the key directors were nominees of the promoters.	The sale of the lease was voidable. Disclosure is only valid if made to an independent body of persons, and this was not the case here.
***Re Northumberland Avenue Hotel Co* (1886)** LR 33 ChD 16 (CA)	A promoter entered into a lease on behalf of a company that was not yet formed. Upon incorporation of the company the following day, the company purported to adopt the lease.	A company, once incorporated, cannot adopt or assume obligations entered into on its behalf at a time when it did not exist. The adoption was therefore invalid.

(p. 21) #### Key debates

Topic	**Promotion of the company**
Author/Academic	Joseph H Gross
Viewpoint	Discusses the courts' approach in determining whether or not a person is a promoter.
Source	'Who is a Company Promoter?' (1970) 86 LQR 493.
Topic	**Pre-incorporation contracts**
Author/Academic	Joseph Savirimuthu
Viewpoint	Discusses the theories behind the common law and statutory rules relating to pre-incorporation contracts, and provides several possible suggestions for reform.
Source	'Pre-Incorporation Contracts and the Problem of Corporate Fundamentalism: Are Promoters Proverbially Profuse?' (2003) 24 Co Law 196.

Exam questions

Essay question

> 'The statutory rules relating to pre-incorporation contracts are much more effective than their common law predecessors.'

Discuss the validity of this statement.

See the Outline answers section in the end matter for help with this question.

Problem question

Andrew and Cathryn Sims are a married couple and partners in a business that sells video games hardware and software. The business proves to be extremely successful, and they open up a number of branches. In order to limit their liability, they instruct their solicitor to incorporate the business, calling the new company Sims Gaming Ltd.

Around the same time, MicroTech is about to release a new games console—the GamePlayer. Andrew and Cathryn are keen to acquire as many of these consoles as possible. Andrew hears of a potential source (Halo Ltd) and is offered 50 consoles. Eager to purchase the consoles, Andrew does not wait until the company is incorporated and enters into a contract with Halo Ltd 'for and on behalf of Sims Gaming Ltd'. Cathryn is also offered a number of consoles and, prior to the company being incorporated, she enters into a contract with Players Ltd for 40 consoles. She signs the contract 'Sims Gaming Ltd pp. Cathryn Sims (a director)'.

(p. 22) The certificate of incorporation is issued and, at the first board meeting of Sims Gaming Ltd, Andrew and Cathryn ratify both contracts. Andrew and Cathryn both have extensive software libraries. Andrew sells to Sims

Gaming Ltd a number of games that he acquired prior to engaging in the company's formation. Cathryn sells to the company a number of games that she acquired whilst the company was being formed.

Shortly thereafter, Halo Ltd refuses to sell Andrew the 50 consoles promised, as it believes that it can sell all the consoles to the public for a higher price. Cathryn is concerned that Players Ltd will also refuse to sell the 40 consoles promised.

A member of Sims Gaming Ltd, William, discovers what has happened and seeks your advice regarding whether or not any breaches of the law have occurred. Would your answer differ if Sims Gaming Ltd had been an off-the-shelf company purchased by Andrew and Cathryn?

Online Resource Centre

To see an outline answer to this question log onto www.oxfordtextbooks.co.uk/orc/concentrate/

Company Law Concentrate: Law Revision and Study Guide (3rd edn)

Lee Roach

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3. Incorporation

Go to page: GO

Chapter: (p. 23) 3. Incorporation
Author(s): Lee Roach
DOI: 10.1093/he/9780198703808.003.0073

Key facts

- Companies (and limited liability partnerships) are formed via a formal process known as ‘incorporation’.
- The vast majority of companies are incorporated by registration, which involves registering certain documents with the Registrar of Companies at Companies House.
- A company can do many things that a natural person can, including entering into contracts, owning property and commencing legal proceedings.
- In the vast majority of companies, the liability of the members will be limited.
- A company can be held liable for a civil wrong, or found guilty of committing a crime.
- A company has corporate personality, which means that, at law, it is a person.
- The courts can set aside a company’s corporate personality where statute so provides, or where a company is interposed in order to evade, or frustrate the enforcement of, a legal obligation.

(p. 24) Introduction

Sole proprietorships and ordinary partnerships can be brought into existence very easily and with minimal state involvement. Conversely, companies (and LLPs) are brought into existence at the discretion of the state via a formal process known as 'incorporation'. The word 'incorporation' is used because successful incorporation brings into existence a 'corporation' (or as **s 16(2) of the CA 2006** terms it, a 'body corporate'). In this chapter, the process of incorporation and the advantages and disadvantages of conducting business through a company will be discussed.

Methods of incorporation

There are three principal methods by which a company can be incorporated:

1. incorporation by Act of Parliament
2. incorporation by Royal Charter
3. incorporation by registration

It should be noted that the provisions of the **CA 2006** generally apply only to companies incorporated by registration (known as registered companies), although they can be extended to cover unregistered companies (i.e. companies incorporated by Act of Parliament or Royal Charter). The vast majority of companies incorporated in the UK are registered, but it is still worth briefly highlighting the two methods of creating an unregistered company.

Incorporation by Act of Parliament

Parliament can create a company by passing an Act of Parliament. For example, organizing the London 2012 Olympic and Paralympic Games was the responsibility of a company called the Olympic Delivery Authority, which was created by the **London Olympic Games and Paralympic Games Act 2006**.

Incorporation by Royal Charter

A company can be created by Royal Charter. Historically, such so-called chartered companies were created personally by the monarch through the exercise of the Royal Prerogative, but today are created by the monarch upon advice from the Privy Council. Prominent examples of companies incorporated by Royal Charter include the Bank of England, the Law Society, and the BBC. Today, very few companies are created by Royal Charter (in 2013, only eight such companies were created) with modern charters being granted almost exclusively to bodies engaged in educational or charitable work (with the most noteworthy recent chartered company being the Recognition Panel, which is the approved regulator of the media recommended by the Leveson Report).

(p. 25) Incorporation by registration

Petitioning Parliament or the monarch is not the most accessible or efficient way of creating a company. Accordingly, a simpler and quicker method of incorporation was created by the **Joint Stock Companies Act 1844**, namely incorporation by registration. Today, the overwhelming majority of new companies are incorporated by registration (in 2012/13, 451,700 companies were incorporated by registration).

The registration process

Incorporation by registration is so called because it involves registering 'registration documents' with the relevant Registrar of Companies. These documents, once registered and authorized, bring a registered company into existence. **Section 9 of the CA 2006** provides that the required documents are the memorandum of association (discussed in more detail at p 46, 'The memorandum of association') and an application for registration. The application for registration will provide certain information, including:

- the company's proposed name
- the address of the company's registered office

- whether the company is to be public or private (discussed at p 9, ‘Public and private companies’)
- whether the members’ liability is to be limited or unlimited and, if limited, whether it is to be limited by shares or by guarantee (discussed at p 12, ‘Limited and unlimited companies’).
- if the members’ liability is to be limited by guarantee, then a statement of guarantee must be included
- if the company is to have a share capital, a statement of capital and initial shareholdings must be included
- a statement identifying the company’s proposed officers (i.e. the first director(s) and, if applicable, the first company secretary).

In addition, a statement of compliance must be registered which states that the statutory requirements regarding registration have been met.

If the Registrar is satisfied that the documents are complete and accurate, he will, upon payment of the registration fee, issue a certificate of incorporation, which provides conclusive proof that the company is validly registered under the **CA 2006** (**CA 2006, s 15(4)**). From this date, the company has all the powers and obligations of a registered company, and the proposed directors will formally become directors, subject to a range of statutory duties (discussed at p 67, ‘Directors’ duties’).

> Looking for extra marks?
>
> You would do well to be aware of the practicalities of incorporating a company (e.g. methods of incorporation by registration, costs of incorporation etc.) and how practice in this area is changing. **(p. 26)** For example, Companies House has stated that it eventually intends for all incorporations to be completed electronically and strongly encourages paperless incorporation via the registration fee, which is notably less for electronic registration than for paper registration. A wealth of practical and up-to-date information relating to the process of incorporation and the number of incorporations can be found at www.companieshouse.gov.uk.

‘Off-the-shelf’ companies

Preparing the registration documents is not unduly burdensome, but does require knowledge of the procedures by which a company is created. Persons who lack such knowledge, or who wish to avoid the time and effort associated with preparing the registration documents, may instead prefer to take advantage of the services of an incorporation agent (also known as a company formation agent). Incorporation agents register the relevant documents and then leave the newly registered company ‘on the shelf’ until such time as it is purchased from them. When purchased, the agent will notify the Registrar of the new owner’s identity and relevant changes (e.g. change of registered office, change of directors, etc.).

> Revision tip
>
> The Company Law Review Steering Group estimated that around 60 per cent of all new companies are initially created as off-the-shelf companies. Be aware of the importance of this method of obtaining a company, and also the advantages (e.g. speed and lack of expense) and disadvantages (e.g. the company may not be tailored to the purchaser’s needs) of purchasing an off-the-shelf company.

Advantages and disadvantages of incorporation

In order to understand the true importance of the company, it is vital that you appreciate the advantages and disadvantages that arise when conducting business through a company.

Revision tip

Students are often aware of the advantages of incorporation, but frequently are unaware that incorporation carries some notable disadvantages. Despite the numerous substantial benefits that incorporation brings, it is not suitable for many businesses, as is evidenced by the fact that unincorporated businesses outnumber incorporated businesses.

Advantages

Carrying on business though a company has a number of significant benefits over carrying on business through an unincorporated structure.

 Corporate personality

The primary advantage, from which many other advantages flow, is that the company acquires corporate (or separate, or legal) personality. This means that the company is regarded by the law as a person. Whereas humans are classed as natural persons, the company is a legal person and can therefore do many things that humans can. As corporate personality is so fundamental, it is discussed in more detail later at p 31, 'Corporate personality'.

Limited liability

As the company is a separate entity, it follows that the members are not usually personally liable for its debts and liabilities—the company itself is liable. However, this does not mean that the members are not liable to contribute anything. Where a company is unlimited, the members' liability will also be unlimited. However, the overwhelming majority of companies are limited, and so the liability of the members will also be limited. The operation of limited liability has already been discussed at p 12, 'Limited and unlimited companies'.

Looking for extra marks?

Limited liability is a powerful incentive to incorporate, but for many smaller companies, it may not provide as substantial a benefit in practice. When lending to a smaller company, banks will often require that the directors/members sign personal guarantees, thereby ensuring that, should the company default on the loan, the relevant directors/members may become personally liable to pay to the bank any part of the loan unpaid by the company. Further, limited companies pay for limited liability in the form of increased regulation (e.g. disclosure requirements). Students are usually aware of the advantages of limited liability, but are often unaware of its disadvantages. For an account of the advantages and disadvantages of limited liability, see Brian R Cheffins, *Company Law: Theory, Structure and Operation* (Clarendon 1997) 497–508.

There is little doubt that limited liability minimizes the risk faced by the members and encourages investment in companies. The problem with limited liability is that, whilst it protects the members, it arguably weakens the position of the company's creditors. In a sole proprietorship or ordinary partnership, the creditors can obtain satisfaction of the debt from the personal assets of the sole proprietor or partners. In a company, the creditors of the company can only usually look to the company for payment. It has therefore been argued that limited liability does not so much minimize the members' risk, but instead shifts it from them and onto the company's creditors.

Looking for extra marks?

Does limited liability really shift the risk from the members onto the creditors? The answer is undoubtedly yes,

but it has been argued that the creditor is fully compensated for the increased risk by the interest charged on the loan. However, smaller creditors may not be powerful enough to negotiate increased interest rates with the company. Further, some creditors are unable to **(p. 28)** negotiate with the company at all (e.g. persons who are owed compensation from the company as a result of the company's tortious acts or omissions). For a detailed discussion, see Frank H Easterbrook and Daniel R Fischel, 'Limited Liability and the Corporation' (1985) 52 Uni Chi LR 89.

Perpetual succession

Companies are not subject to the physical weaknesses that natural persons are subject to. Accordingly, companies can continue forever and there are many existing companies that are centuries old. Members and directors can come and go, but the company remains (see the Australian case of ***Re Noel Tedman Holdings Pty Ltd*** **[1967]**) for a stark example of this). Compare this to a partnership which, upon the death of a partner, may be dissolved.

Contractual capacity

As the company is a person, it can enter into contracts with persons both inside and outside the company.

Lee v Lee's Air Farming Ltd [1961] AC 12 (PC)

FACTS:

Lee was employed as a pilot by a company in which he held 2,999 shares (out of 3,000 in total) and of which Lee was the only director. Whilst engaged on company business, his plane crashed and he was killed. His widow sought compensation for his death from the company, which, under the relevant legislation, was payable only to the widows of deceased employees. The company's insurers argued that Lee was not an employee of the company, on the basis that he was synonymous with the company and had therefore made a contract with himself (which is not permitted by the law, as agreement required two parties).

HELD:

Lee's widow was entitled to compensation. Lee had not made a contract with himself; rather he had made a contract with the company, which was a separate entity. The fact that he owned virtually all the shares and was its only director did not change that fact that the company was the employer and he was its employee.

The extent of a company's ability to enter into contracts (i.e. its contractual capacity) is discussed at p 53, 'The capacity of a company'.

Ownership of assets

The assets of the company belong to it as a legal person. This allows for a clear separation between the property of the company and the property of the members, and the members have no proprietary interest in the company's assets.

Macaura v Northern Assurance Co Ltd [1925] AC 619 (HL)

FACTS:

Macaura owned a timber yard. He created a company and transferred all of the timber to this new company, in return for which he obtained a number of shares in the company. He then **(p. 29)** insured the timber, in his own

name, against loss caused by fire. Subsequently, the timber was destroyed in a fire, but the insurance company refused to pay out.

HELD:

The insurance company was entitled to refuse payment as, whilst the timber was insured in Macaura's name, it did not belong to him—it belonged to the company he created. Accordingly, Macaura had no insurable interest in the timber and so could not claim on the insurance policy.

The ability to commence legal proceedings

Determining who can sue in cases involving unincorporated businesses (especially partnerships) has historically proven to be an extremely difficult issue. No such difficulty exists in relation to companies, as it is clear that where a company is wronged, it is the company, as a person, who is usually the proper claimant. However, in certain cases, the members can commence proceedings for a wrong done to the company via what is known as a derivative claim (discussed at p 139, 'The derivative claim').

Transferable shares

In a partnership, the transfer of one partner's interest to another can be an extremely complex process, and can adversely affect the operation of the partnership. Conversely, transferring interests in a company is straightforward, due to the transferable nature of the share. A shareholder who wishes to transfer his interest in the company need only sell his shares, and his interest in the company will come to an end.

Floating charges

Companies have access to a specific form of security known as a 'floating charge' (discussed at p 131, 'Floating charges'). Currently, sole proprietors and ordinary partnerships are not permitted to grant floating charges. Access to this form of security makes it easier for companies to borrow money, when compared to sole proprietors and ordinary partnerships which, despite their unlimited liability, often find it difficult to raise debt capital.

Human rights

As a company is a person, it follows that certain pieces of law that protect persons can also apply to companies. For example, the **European Convention on Human Rights** not only protects natural persons, but a number of its provisions also offer protection to legal persons too (accordingly, the word 'human' in the title could be regarded as inaccurate). For example, **Art 1 of the First Protocol** of the Convention provides that 'Every natural or legal person is entitled to the peaceful enjoyment of his possessions.'

Disadvantages

Whilst incorporation carries some notable benefits, a promoter considering incorporation should also be aware of several disadvantages.

(p. 30) Increased formality, regulation and publicity

Companies are subject to significantly more formality and regulation than unincorporated businesses. Setting up a company is a more complex task than setting up a sole proprietorship or ordinary partnership. The increased formality and regulation extends beyond formation, and complex rules can apply throughout the company's existence (e.g. the rules relating to the calling and running of general meetings, which are discussed at p 91, 'Meetings'). Directors are subject to a raft of statutory duties (discussed at p 67, 'Directors' duties') that sole proprietors and partners are not subject to. Incorporation also results in a loss of privacy, as most companies are required to make certain information (e.g. financial accounts) publicly available throughout their existence.

Looking for extra marks?

You should be aware of why companies are subject to so much regulation. Put simply, corporate regulation (especially the rules relating to financial disclosure) is the price the company pays for having the benefits of corporate personality and for being able to offer its members limited liability. Creditors, knowing that they will normally be unable to look to the company's members for satisfaction of their debt, will understandably want to investigate the financial affairs of the company in order to decide whether to loan the company capital, or on what terms the capital will be loaned. This is easily done, as limited companies are required to publicly disclose their financial accounts.

Civil liability

As discussed at p 29, 'The ability to commence legal proceedings', if a company has been wronged, it can commence legal proceedings to redress that wrong. Similarly, if a company commits a civil wrong, it can be sued and made liable to pay compensation. However, the fact that a company must act through natural persons (namely its directors, officers, agents and employees) can cause problems. To what extent is the company liable for the civil wrongs of those persons who act on its behalf? In many cases, imposing liability upon the company for the civil wrongs of its directors/employees poses no problem, as the company can be made liable via the doctrine of vicarious liability (in the case or tortious liability) or via the law of agency (in relation to contractual liability). However, the issue is often more complex as certain civil wrongs require defendants to have a certain level of knowledge that the company, as an entity, will lack for obvious reasons.

The law's answer is to utilize what is known as 'identification theory', which states that the knowledge of certain persons will be attributed to the company (i.e. the knowledge of such persons will be regarded as the knowledge of the company). However, the courts will only attribute to the company the knowledge of persons who constitute the 'directing mind and will' of the company (***Lennard's Carrying Co Ltd v Asiatic Petroleum Co Ltd*** **[1915]**). In the majority of cases, this will be limited to the directors and senior officers of the company, and to persons in management to whom the directors have delegated managerial functions (***Tesco Supermarkets Ltd v Nattrass*** **[1972]**).

(p. 31) Criminal liability

Just as a company can be found liable for committing a civil wrong, so too can it be found guilty of committing a crime. However, in the case of ***R v ICR Haulage Ltd*** **[1944]**, it was held that, as a company cannot be imprisoned, it cannot be found guilty of any crime for which the only punishment is imprisonment (e.g. murder). Where the crime is one that requires *mens rea*, the courts will utilize identification theory (previously discussed) and attribute *mens rea* to those who are the 'directing mind and will' of the company. A notable relaxation of this rule exists in relation to corporate manslaughter. At common law, the courts would only impose liability on the company if the death was the result of the actions and gross negligence of an identifiable member of the directing mind and will of the company (***Attorney General's Reference (No 2 of 1999)*** **[2000]**). The lack of successful prosecutions resulted in the passing of the **Corporate Manslaughter and Homicide Act 2007**, which provides that corporate manslaughter will be committed by an organization if the way in which its activities are managed or organized:

1. causes a person's death
2. amounts to a gross breach of the relevant duty of care owed by the organization to that person, and
3. the way in which the organization is managed or organized by its senior management is a substantial element of that breach.

Accordingly, it is much easier to obtain a conviction under the 2007 Act, as there is no need to identify an individual's actions with the cause of death.

Looking for extra marks?

Despite the fact that the 2007 Act was designed to make it easier to obtain a conviction for corporate manslaughter, the first successful prosecution under the Act did not occur until February 2011 (see ***R v Cotswold Geotechnical Holdings Ltd* [2011]**). This case was even more striking as the Court of Appeal held that the fine imposed upon the company (£385,000 payable over ten years) was appropriate even though it would inevitably put the company out of business (which occurred in June 2011 when the company was liquidated).

Corporate personality

Upon incorporation, the company becomes a person in its own right and can do many things that a natural person can do. Corporate personality was available to unregistered companies, but with the passing of the **Joint Stock Companies Act 1844** and the ability to incorporate a company by registration, corporate personality took on a new-found importance. However, despite this, it was over 50 years later, in the following landmark case, that the courts finally appreciated the true significance of corporate personality.

(p. 32) *Salomon v A Salomon & Co Ltd* [1897] AC 22 (HL)

FACTS:

Salomon was a sole trader engaged in the business of bootmaking. He created a new company and sold the bootmaking business to this new company, in return for which Salomon received shares and £10,000 worth of debentures, secured by a floating charge. Salomon held 20,001 shares and six members of his family held one share each (the **Companies Act 1862** required companies to have a minimum of seven members), although they took no part in the business. The business soon failed and the company entered liquidation. Salomon used the floating charge to recover the £10,000 owed to him, but this meant that there were no remaining assets to pay the company's other creditors. The liquidator argued that Salomon should be personally liable for the company's debts, as the company was his agent or trustee.

HELD:

Salomon was not personally liable for the company's debts. The company was not an agent or trustee for Salomon—it was a separate entity, with which the creditors had contracted. Accordingly, its debts were not Salomon's debts and, as his debt outranked the debts of the other creditors (the ranking of debts is discussed at p 170, 'Distribution of assets'), he was entitled to the money owed to him.

Looking for extra marks?

Be aware of the true significance of ***Salomon***. Many students incorrectly believe that ***Salomon*** created the concept of corporate personality, but this is not the case (for a discussion of the history and origins of corporate personality, see Paddy Ireland, 'The Conceptual Foundations of Modern Company Law' (1987) 14 J Law & Soc 149). ***Salomon*** is regarded by many as the most important case in company law for three reasons:

1. it recognized that a company could legitimately be set up to shield its members and directors from liability
2. it implicitly recognized the validity of the 'one-man company' (i.e. a company run by one person, with a number of dormant nominee members) nearly a century before single person companies could formally be created, and

3. the fact that a person holds shares (even, all the shares) is not enough to create a relationship of agency or trusteeship.

There is no doubt that ***Salomon*** is the cornerstone upon which UK company law is based. However, the ability to set up a company to shield oneself from liability is clearly open to abuse. Accordingly, both Parliament and the courts have the ability to ignore a company's corporate personality and impose liability upon those behind the company's corporate personality. This is known as 'piercing' or 'lifting' the 'veil'—referring to the 'corporate veil' that hides the company's members and directors from liability.

Revision tip

Corporate personality and piercing the veil are popular exam topics. Essay questions typically focus on ***Salomon*** or the validity and clarity of those instances when the courts will pierce the corporate veil (an area which has undergone substantial change recently, as is discussed later). Problem questions tend to require students to determine if a company's corporate personality will be upheld or ignored.

(p. 33) Statute

As companies are granted corporate personality by statute (namely, **s 16(2) of the CA 2006**), it follows that statute can set aside corporate personality and impose liability on those behind the veil. Notable examples include:

- If a public company carries on business, or exercises any borrowing powers, prior to being issued with a trading certificate, then the directors can be made personally liable (**CA 2006, s 767**).
- Where, in the course of winding up a company, it appears that the company has been run with an intent to defraud the creditors (known as fraudulent trading), the court may lift the veil and impose personal liability on any persons who were knowing parties to such conduct (**Insolvency Act 1986, s 213**) (discussed at p 167, 'Fraudulent trading').
- Where a company has gone into insolvent liquidation, the directors may be personally liable if they continued trading when they knew, or ought to have known, that there was no reasonable prospect of the company avoiding liquidation (known as wrongful trading) (**Insolvency Act 1986, s 214**) (discussed at p 167, 'Wrongful trading').

Common law

As corporate personality is bestowed by statute, it follows that the courts are reluctant to pierce the veil, as the following case demonstrates.

Adams v Cape Industries plc [1990] Ch 433 (CA)

FACTS:

The defendant parent company (Cape) was based in England. A subsidiary of Cape was based in South Africa where it mined asbestos. The asbestos was sold by other subsidiaries, one of which was based in Illinois, USA. The asbestos was sold to a factory in Texas and a number of the factory's employees developed asbestos-related medical conditions. A US court ordered that $15 million be paid in damages, but this could only be enforced in the UK against Cape if the claimants could show that Cape was present in the USA. Accordingly, the claimants argued that Cape was present in the USA through its Illinois subsidiary. For this argument to succeed, the separate personalities of the various companies would need to be ignored.

(p. 34) **HELD:**

The Court refused to lift the veil and held that the US subsidiary was separate and distinct from its UK parent. Accordingly, Cape was not present in the USA and the judgment of the US court could not be enforced against it. ***Salomon*** allowed a parent to use its subsidiaries to avoid liability in this way, and the Court was of the opinion that, on the facts, there were no grounds to avoid following ***Salomon***.

In ***Adams***, the claimants put forward four arguments for piercing the corporate veil:

1. the US subsidiary was a fraud or a sham,
2. the group of companies constituted one 'single economic unit',
3. the US subsidiary was an agent of Cape, and
4. lifting the veil was fair and just given the circumstances of the case.

All of these arguments failed (the first three on the facts, and the fourth was not regarded as a valid ground to pierce the veil) and the Court strongly reaffirmed the principle in ***Salomon*** and indicated that corporate personality will not be lightly cast aside. It should be noted at the outset that the extent to which some the instances discussed can be regarded as genuine examples of piercing the veil has been doubted by the Supreme Court in what is now the leading case, namely ***Petrodel Resources Ltd v Prest* [2013]**. In order to fully understand the significance of ***Prest***, it is important to look at the common law position before the Supreme Court decision in ***Prest***, beginning with the courts' ability to pierce the veil in cases where the company was being used to perpetrate a fraud, or where it was being used to evade a legal obligation (which, following ***Prest***, is likely to be the only instance in which the veil can be pierced).

Fraud, sham or cloak

The most straightforward and least problematic instance of when the courts could pierce the veil was where the company was being used to perpetrate a fraud, or where the company was a façade or a sham, or was used to evade some form of wrongdoing. A common theme amongst such cases is that the company was used to evade some form of existing contractual provision or obligation, as the following case demonstrates.

Gilford Motor Co Ltd v Horne [1933] Ch 935 (CA)

FACTS:

The defendant was the managing director of the claimant company. His employment contract provided that, should he leave the company, he would not attempt to solicit any of its customers. His employment was terminated, and his wife set up a rival company, which competed directly with the claimant. It was clear that this new company was set up at the defendant's behest and was under the defendant's control.

HELD:

The Court granted an injunction preventing the defendant (and the new company) from soliciting the claimant's customers. Lord Hanworth MR stated that the new company was 'formed (p. 35) as a device, a stratagem, in order to mask the effective carrying on of a business of [the defendant]' and to avoid the restrictive covenant.

In ***Antonio Gramsci Shipping Corp v Stepanovs* [2011]**, Burton J, during the course of his judgment, laid down a number of principles to apply in cases involving companies set up fraudulently:

- The defendant need not be in sole control of the company in question—where there were a number of wrongdoers, with a common purpose, in control of the company, then liability could be imposed on all, of one, of them.

- The veil would not be pierced simply because the company behaved fraudulently—what must be established is that there was a fraudulent misuse of the company structure.
- The veil will only be pierced where the fraud or wrongdoing in question is within the ordinary business of the company in question.
- A contract entered into by a 'puppet company' could be enforced against both the puppet company and puppeteer (i.e. the wrongdoer(s) in control of the company), although the puppeteer would not be permitted to enforce the contract on policy grounds. However, in the following case, the Supreme Court overruled ***Gramsci*** on this point and held that the puppeteer would not be bound.

VTB Capital plc v Nutritek International Corp [2013] UKSC 5

FACTS:

VTB Capital plc (VTB) lent US$225 million to Russagroprom LLC (RAP), which RAP intended to use to purchase a number of Russian companies from Nutritek. RAP defaulted on the loan. VTB alleged that it was induced into entering into the loan agreement with RAP based on fraudulent misrepresentations made by Nutritek. VTB alleged that representations were made indicating that RAP and Nutritek were not under common control, whereas both companies were, in reality, controlled by Mr Malofeev, a Russian entrepreneur. VTB commenced proceedings against Nutritek, Malofeev and several other companies that were involved, alleging that they were liable for RAP's breach of contract. In order for this claim to succeed, the corporate personality of RAP would need to be pierced and VTB argued that the veil should be pierced on the ground that Malofeev and his associated companies were using RAP as a puppet company to orchestrate a fraud against VTB. VTB claimed that once the veil was pierced, the defendants would become party to the original loan agreement between VTB and RAP, and so would be liable on it.

HELD:

The Supreme Court refused to pierce the corporate veil. Lord Neuberger stated that, to find the defendants liable on the loan agreement, would involve an extension of the circumstances in which the veil could be pierced. It would, in effect, result in Malofeev becoming a co-contracting party with RAP under the loan agreement. He refused to do this on the ground that where B and C are the contracting parties and A is not, there is simply no justification for holding A responsible for B's contractual liabilities to C simply because A controls B and has made misrepresentations about B to **(p. 36)** induce C to enter into the contract. This could not be said to result in unfairness to C: the law provides redress for C against A, in the form of a cause of action in negligent or fraudulent misrepresentation

Groups of companies

It is common for larger companies to carry out their functions via a number of smaller subsidiary companies. Are the various companies in a group to be regarded as having separate corporate personalities, or are they to be regarded as one 'single economic unit'? The general rule was stated by Roskill LJ in ***The Albazero* [1977]** when he stated that it was 'long established and now unchallengeable by judicial decision … that each company in a group of companies … is a separate entity possessed of separate legal rights and liabilities'.

The decision of the House in ***The Albazero*** was intended to reaffirm the principle laid down in ***Salomon*** and to ensure that the law remained certain. Unfortunately, the following difficult case, decided a year after ***The Albazero***, introduced a measure of unwelcome uncertainty into the law.

DHN Food Distributors Ltd v Tower Hamlets LBC [1976] 1 WLR 852 (CA)

FACTS:

DHN was a holding company that included two other wholly owned subsidiaries. One of these subsidiaries owned the land upon which DHN conducted business, with DHN occupying the land as a bare licensee. The land was compulsorily purchased by the defendant, who paid £360,000 compensation to the subsidiary. DHN could not find suitable replacement premises, and went into liquidation. DHN argued that it was entitled to compensation for loss of business, but the law provided that only those with a legal or equitable interest in the land were entitled to such compensation, with a bare licence not conferring such an interest.

HELD:

DHN was awarded compensation for loss of business. Lord Denning MR stated that the subsidiaries were 'bound hand and foot' to DHN and that '[t]he group is virtually the same as a partnership where all three companies are partners'. Accordingly, the three companies were treated as one, with DHN regarded as that one.

Looking for extra marks?

DHN is a much-criticized case. Although the three judges all agreed that the veil should be pierced, they could not agree on the reasons why. Lord Denning MR's judgment is regarded as the leading judgment, but his analysis is arguably flawed. He stated that the subsidiary was 'bound hand and foot' to DHN and 'must do just what the parent company says', but then went on to describe them as 'partners'. Can a subsidiary that has to follow the instructions of its parent realistically be regarded as a 'partner?' It seems unlikely.

Whilst ***DHN*** has not been overruled, there is little doubt that subsequent courts have been critical of the case with the Court of Appeal in ***Adams v Cape Industries*** **[1990]** and the House of Lords in ***Woolfson v Strathclyde Regional Council*** **[1979]** expressing doubts as to the correctness of the decision in ***DHN***. However, until it is overruled, uncertainty will remain as the possibility of a court applying ***DHN*** still exists (although, following the decision of the Supreme Court in ***Prest*** (discussed later), it is likely that it would not be regarded as piercing the veil).

(p. 37) Agency

A relationship of agency usually arises where one person (known as the principal) appoints another person (known as the agent) to act on his behalf. Where two parties are involved in an agency relationship, the principal is normally legally responsible for the acts of his agent. In the corporate context, a relationship of agency can arise in two situations:

1. The company could be regarded as an agent of a member, so that the member, as principal, is liable for the acts of the company (i.e. the company's corporate personality is ignored and the member made liable). However, as discussed at p 32, 'Corporate personality', ***Salomon*** emphatically stated that the mere fact of incorporation does not cause a relationship of agency to be created between the company and its members, although an agency relationship between the company and its members can arise on the particular facts of a case (see e.g. ***Gramophone & Typewriter Ltd v Stanley*** **[1908]**).
2. Where two companies are in an agency relationship, the principal (normally the parent or holding company) can be liable for the acts of its agent (normally, a subsidiary company). In effect, the corporate personality of the subsidiary is ignored and the parent company is made liable for the subsidiary's acts. The following case provides an example of when such an agency relationship arose.

Smith, Stone and Knight Ltd v Birmingham Corporation [1939] 4 All ER 116 (QB)

FACTS:

The claimant company purchased a business, and set up a new subsidiary company to run this business. However, the claimant never transferred ownership of the business to the newly created subsidiary. The land upon which the subsidiary conducted business was compulsorily purchased by the defendant, who planned to pay compensation to the subsidiary for loss of business. The claimant contended that it was entitled to the compensation.

HELD:

The subsidiary was the agent of the claimant and, therefore, the corporate personality of the subsidiary was ignored and the claimant obtained the compensation. The crucial factor was that the newly acquired business and the land on which it operated still belonged to the claimant.

Revision tip

The facts of ***Smith, Stone and Knight Ltd*** are somewhat similar to the facts of ***DHN Food Distributors Ltd*** discussed earlier, and it is common for students to confuse the two cases. Indeed, company law texts sometime incorrectly regard them as part of the same exception to ***Salomon***. Make sure that you are aware of the differences between the two cases.

(p. 38) Cases such as ***Smith, Stone and Knight Ltd*** are rare. In the vast majority of cases, in the absence of an express agency agreement, a relationship of agency will not exist between a parent and its subsidiaries (even if the parent owns 100 per cent of the subsidiary's shares). However, as noted, a relationship of agency may exist based on the facts of a case, but exactly what type of facts will cause an agency relationship to arise is unclear. It should also be noted that, following ***Prest***, the finding on an agency relationship and the subsequent imposition of liability on a parent will likely not be regarded as piercing the veil.

Justice or convenience

Should the courts be allowed to pierce the corporate veil where justice demands? The Court of Appeal has demonstrated inconsistency in answering this question:

- In ***Re a Company* [1985]**, Cumming-Bruce LJ stated that 'the court will use its powers to pierce the corporate veil if it is necessary to achieve justice'.
- In ***Adams v Cape Industries plc* [1990]**, Slade LJ stated that 'the court is not free to disregard the principle of ***Salomon*** … merely because it considers that justice so requires'.

There is little doubt that the view in ***Adams*** is currently the dominant view, and the courts will not pierce the veil simply because justice demands. Such an approach would produce considerable inconsistency, as what one judge might regard as just may be regarded as unjust by another judge.

Looking for extra marks?

The possibility of piercing the veil in the name of justice is often overlooked by students. Despite the current dominance of the view in ***Adams***, there is little doubt that a significant number of senior judges would welcome the ability to pierce the veil in the name of justice (see e.g. the judgment of Auld LJ in ***Conway v Ratiu* [2005]**).

The new approach

The decision of the Court of Appeal in ***Adams v Cape Industries plc*** clearly indicates that the courts are not quick to pierce the veil and the number of grounds upon which the veil can be pierced is limited. The Supreme Court case of ***Petrodel Resources Ltd v Prest* [2013]** has further limited the grounds on which the veil can be pierced by stating that there is only one instance in which the veil can be pierced and, even in that instance, the veil will only be pierced if it is necessary to do so. ***Prest*** must now be regarded as the leading case in this area and casts significant doubt on the validity of many of the cases discussed (at least in terms of them being regarded as instances of piercing the veil).

Petrodel Resources Ltd v Prest [2013] UKSC 34

FACTS:

The case involved a divorce settlement between Mr and Mrs Prest. The High Court had awarded Mrs Prest a divorce settlement totalling £17.5 million, but much of Mr Prest's assets were **(p. 39)** tied up in companies that were solely controlled by him. **Section 24(1)(a) of the Matrimonial Causes Act 1973** grants the court the power to 'order that a party to the marriage shall transfer to the other party … property to which the first mentioned party is entitled'. The High Court utilized this power to pierce the corporate veils of these companies and order the relevant properties to be transferred to Mrs Prest. Mr Prest appealed, questioning whether the court had the power to do this given that the properties did not belong to Mr Prest, but to his companies. The Court of Appeal, in allowing Mr Prest's appeal, held that the veil could not be pierced in these circumstances and so the High Court had no jurisdiction to make the order under **s 24(1)(a)**. Mrs Prest appealed.

HELD:

The appeal was unanimously allowed, but not on the ground that the veil could be pierced. The Supreme Court held that the properties were held on trust by the companies for the benefit of Mr Prest and, as such, they could form part of the divorce settlement. More importantly for present purposes, the Court unanimously refused to pierce the corporate veil and significantly limited the instances in which the veil could be pierced. The leading judgment of Lord Sumption began by looking at what piercing the corporate veil actually means:

> Properly speaking, it means disregarding the separate personality of the company. There is a range of situations in which the law attributes the acts or property of a company to those who control it, without disregarding its separate legal personality. The controller may be personally liable, generally in addition to the company, for something that he has done as its agent or as a joint actor. Property legally vested in a company may belong beneficially to the controller, if the arrangements in relation to the property are such as to make the company its controller's nominee or trustee for that purpose… But when we speak of piercing the corporate veil, we are not (or should not be) speaking of any of these situations, but only of those cases which are true exceptions to the rule in Salomon … i.e. where a person who owns and controls a company is said in certain circumstances to be identified with it in law by virtue of that ownership and control.

Accordingly, it is clear that Lord Sumption does not regard many of the cases discussed as true situations in which the veil was pierced (especially those cases involving groups of companies or a relationship of agency). Accordingly, the question is when can the courts pierce the veil? Lord Sumption stated that there was only one instance in which the courts could pierce the veil, namely where 'a person is under an existing legal obligation or liability or subject to an existing legal restriction which he deliberately evades or whose enforcement he deliberately frustrates by interposing a company under his control'. Further, a court could only pierce the veil in this instance if 'all other, more conventional, remedies have proved to be no assistance'.

Looking for extra marks?

It is vital that you appreciate the importance of ***Prest*** and the effect that it has had upon prior law. The result of ***Prest*** is that many cases that were previously thought to be instances of piercing the veil must no longer be regarded as such. Derek French, Stephen Mayson and Christopher Ryan in *Mayson, French & Ryan on Company Law* (30th edn, OUP 2013) have contended that the limitations established **(p. 40)** by the Supreme Court could mean that 'it is unlikely that there will in the future be a case in which the two conditions imposed by the Supreme Court will be met and it will be correct to pierce the corporate veil.' Whether this statement proves correct depends on whether the courts are willing to provide new grounds for piercing the veil. Clearly, Lords Sumption and Neuberger were of the opinion that the courts should not create new grounds on which to pierce the veil, but other Justices (namely Lords Mance and Clarke) were open to the idea, albeit with Lord Mance stating that such instances would be 'novel and very rare'. For a discussion of ***Prest***, see Ernest Lim, 'Salomon Reigns' (2013) 129 LQR 480.

A direct duty of care

In ***Prest***, Lords Sumption and Neuberger were clearly of the opinion that many of the cases that are traditionally regarded as examples of piercing the veil did not in fact involve a piercing of the veil, and that the same result could be achieved in some other way. Lord Neuberger even went so far as to say that there has never been 'a single instance in this jurisdiction in which the doctrine [of piercing the veil] has been invoked properly and successfully'. The result is that, in certain cases, the courts can, by alternative means, achieve the same result as if they pierced the veil without actually having to pierce the veil. The following case provides a good example of a case where the Court was able to impose liability on a parent company for the acts of a subsidiary without piercing the corporate veil.

Chandler v Cape plc [2012] EWCA Civ 525

FACTS:

Mr Chandler (the claimant) was, for periods between 1959 and 1962, an employee of Cape Building Products Ltd (CBP), a subsidiary of Cape plc. In 2007, Chandler discovered that he had contracted asbestosis as a result of being exposed to asbestos whilst working for CBP. He sought to obtain compensation, but CBP had been dissolved many years before and, during Chandler's period of employment, CBP had no insurance policy in place that would indemnify Chandler for his loss. Accordingly, Chandler commenced proceedings against the parent, Cape plc.

HELD:

The Court held that Cape plc assumed responsibility towards Chandler and so owed him a duty of care, which it had breached. Accordingly, Cape plc was ordered to pay damages to Chandler.

Looking for extra marks?

Chandler is an important case, but it is important to understand its current impact. The Court emphatically rejected any suggestion that the imposition of liability on Cape plc involved a piercing of the corporate veil. The Court stated clearly that the duty was based on Cape assuming a responsibility towards Chandler, which it had breached. The Court was also keen to stress that the duty of care owed by a parent company to the employees of its subsidiaries did not arise automatically, and would only occur where the three-stage test in ***Caparo Industries plc v Dickman*** **[1990]** was met. Accordingly, whilst ***Chandler*** is not an example of the courts

piercing the veil, it does demonstrate that liability can be imposed on a parent for the actions of its subsidiary without having to pierce the corporate veil. It will be interesting to see how the law develops following ***Chandler***, and whether subsequent courts will seek to limit its impact, or widen its application.

(p. 41) Key cases

Case	Facts	Principle
***Adams v Cape Industries plc* [1990]** Ch 433 (Ch)	A US court held that a US subsidiary was liable to pay damages to the US claimants. The claimants wanted to enforce the judgment against the English parent company in an English court, but could only do this if the parent was present in the USA. To do this, the separate personality of the subsidiary had to be ignored.	Each company in a group has its own separate corporate personality. The US subsidiary was separate and distinct from its English parent and the claimants could not therefore enforce the US judgment in an English court.
***Chandler v Cape plc* [2012]** EWCA Civ 525	The claimant contracted asbestosis whilst working for a subsidiary of the defendant. When the claimant discovered his condition, the subsidiary had long since been dissolved, so the claimant commenced proceedings against the subsidiary's parent.	A parent company can owe a duty of care directly to an employee of its subsidiary, providing that the three-stage test for establishing duty has been satisfied. This does not involve piercing the corporate veil.
***Gilford Motor Co Ltd v Horne* [1933]** Ch 935 (CA)	The defendant attempted to avoid a restrictive covenant by conducting business through a company set up by his wife.	Corporate personality will be cast aside where a company is a sham or is used to evade a contractual obligation.
***Lee v Lee's Air Farming Ltd* [1961]** AC 12 (PC)	The sole director (and majority shareholder) of a company entered into a contract of employment with that company. He was killed whilst working for the company, but the insurance company refused to pay compensation to his widow.	As the company is a legal person, it can enter into binding contracts, with persons inside the company, as well as those outside the company.
***Macaura v Northern Assurance Co Ltd* [1925]** AC 619 (HL)	The claimant transferred his stock of timber to a company and took out, in his own name, an insurance policy insuring against loss caused to the timber by fire.	The assets of the company are separate from the assets of its members, and the members have no proprietary interest in the company's assets.
***Petrodel Resources Ltd v Prest* [2013]** UKSC 34	Mrs Prest was awarded a divorce settlement of £17.5 million, but most of Mr Prest's assets were tied up in companies that he controlled. Mrs Prest argued that the corporate personalities of these companies should be pierced.	The veil will only be pierced where (i) a person interposes a company in order to evade, or frustrate the enforcement of, an existing legal obligation or restriction, and (ii) other conventional remedies have

UKSC 34		other conventional remedies have been exhausted.
***Salomon v A Salomon & Co Ltd* [1897]** AC 2 (HL)	Salomon sold his business to a company that he created, in return for shares and a debenture, secured by floating charge. The company failed and Salomon enforced the charge and recovered the monies owed to him. As a result, the company's other creditors went unpaid. The liquidator argued that Salomon should be personally liable.	Setting up a company to shield the directors or members from liability is a legitimate use of the corporate form.

(p. 42) Key debates

Topic	**Limited liability**
Author/Academic	Frank H Easterbrook and Daniel R Fischel
Viewpoint	Argues that limited liability does not eliminate the risk of business failure, but rather shifts it from the company's members onto its creditors.
Source	'Limited Liability and the Corporation' (1985) 52 Uni Chi LR 89.

Topic	**Corporate personality**
Author/Academic	Smadar Ottolenghi
Viewpoint	Provides an interesting and alternative classification relating to when the courts will pierce the corporate veil, namely (i) peeping behind the veil, (ii) penetrating the veil, (iii) extending the veil, and (iv) ignoring the veil.
Source	'From Peeping Behind the Corporate Veil, to Ignoring it Completely' (1990) 53 MLR 338.

Exam questions

Essay question

Otto Khan-Freund famously described ***Salomon v A Salomon & Co Ltd*** as 'a calamitous decision'. Discuss the impact and importance of the case and the justifications behind the decisions of the various courts. Do you agree with Khan-Freund's statement?

See the Outline answers section in the end matter for help with this question.

Problem question

DriveTech plc is engaged in the business of designing and manufacturing high-performance racing cars. It wishes to build a racetrack upon which it can test its prototype models and, to that (p. 43) end, it creates a subsidiary company called TrackBuild Ltd. A suitable piece of land on which to build the testing track is located and TrackBuild purchases it using capital borrowed from DriveTech. However, shortly thereafter, the directors of TrackBuild (all of whom are also directors of DriveTech) discover that the land does not have planning permission and so TrackBuild agrees to sell the land to BuildCorp Ltd, a local construction company. However, several days later, a member of the local council indicates to the directors of TrackBuild that, should it apply for planning permission, it would certainly be granted. Accordingly, before sale of the land to BuildCorp is completed, TrackBuild transfers ownership of the land to DriveTech, and argues that the contract with BuildCorp is no longer valid as it no longer owns the land. TrackBuild successfully applies for planning permission.

DriveTech decides that it wishes to expand into the consumer car market and, to this end, it creates another subsidiary called GearShift Ltd. The articles of GearShift provide that only directors nominated by DriveTech may sit on its board and, accordingly, all the directors of GearShift are either persons nominated by DriveTech, or are actually also directors of DriveTech. GearShift engages in research and development on a new car and this is funded exclusively by issuing shares that are purchased by DriveTech (with the result that GearShift becomes a wholly-owned subsidiary). However, more capital is required, but the directors of DriveTech refuse to provide GearShift with any more capital and instead order the board of GearShift to cut back on its research and development. Accordingly, the directors of GearShift agree to cut back on research into the car's safety features. GearShift finishes designing a new car and it is manufactured and sold to the public. However, the car turns out to be unsafe due to a defect in the car's brakes and numerous accidents occur. Those who suffered injury and loss due to the defective cars initiate proceedings against GearShift but, by this time, GearShift has entered insolvent liquidation, and has insufficient funds to meet any liability.

Advise the parties of any potential liability they might face.

Online Resource Centre

To see an outline answer to this question log onto www.oxfordtextbooks.co.uk/orc/concentrate/

Law Trove

Company Law Concentrate: Law Revision and Study Guide (3rd edn)

Lee Roach

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4. The constitution of the company

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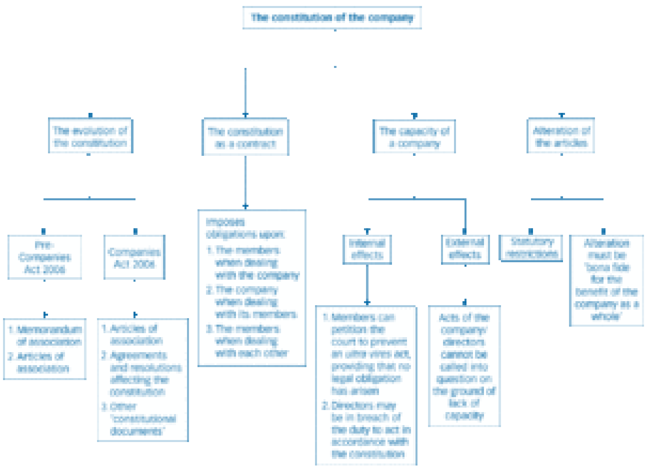
Chapter: (p. 44) 4. The constitution of the company
Author(s): Lee Roach
DOI: 10.1093/he/9780198703808.003.0157

Key facts

- A company’s constitution consists primarily of the articles of association, and agreements and resolutions affecting the company’s constitution.
- The Companies Act 2006 has significantly reduced the importance of the memorandum of association, and the articles now form the company’s principal constitutional document.
- The constitution forms a statutory contract between the company and its members, and between the members themselves, but only those provisions relating to membership rights will constitute terms of the statutory contract.
- A company that acts outside the scope of its objects clause will be acting *ultra vires*.
- Companies incorporated under the Companies Act 2006 have unrestricted objects by default.
- A company can alter its articles by passing a special resolution, although statute and the common law restrict a company’s ability to alter its articles.

(p. 45) Chapter overview



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(p. 46) Introduction

Despite being the largest piece of legislation ever passed, the **CA 2006** does not seek to exhaustively regulate the internal affairs of companies. Much is left to the companies themselves who will usually create their own internal rules via the company's constitution. A company's constitution largely fulfils the same function as the constitution of a country, namely to set out the powers, rights and obligations of those who are subject to the constitution. Accordingly, a company's constitution aims to set out the powers, rights and obligations of the company's members and directors, and also to lay down certain processes regarding how the company is to be run.

The evolution of the corporate constitution

The **CA 2006** has altered significantly the form and content of the corporate constitution. Prior to the passing of the **CA 2006**, a company's constitution consisted primarily of two documents, namely (i) the memorandum of association, and (ii) the articles of association. **Section 17 of the CA 2006** now provides that a company's constitution will include:

1. the company's articles, and
2. resolutions and agreements affecting the company's constitution.

Accordingly, the memorandum no longer forms a principal component of the constitution and, as is discussed, its importance and content are greatly diminished. As **s 17** uses the word 'include', it is clear that it does not provide an exhaustive definition of the constitution and other documents will also form part of a company's constitution. For example, **s 32 of the CA 2006** provides the members with a right to request 'constitutional documents', which will include the documents referred to in **s 17**, but will also include a copy of the company's certificate of incorporation and, in the case of a limited company, a statement of capital or guarantee.

Revision tip

The form and content of the constitution (notably the changing roles of the articles and memorandum) under prior law is still worth knowing, especially if an essay requires you to discuss the changes brought in by the **CA 2006** in relation to the company's constitution. In a problem question, the application of the law may differ

depending on whether the company was incorporated under the **CA 2006**, or under a prior Companies Act.

The memorandum of association

Prior to the **CA 2006**'s enactment, the memorandum was of fundamental importance and formed one of the two principal documents that formed a company's constitution. To simplify company formation and to make it easier to discover the constitutional workings of a company, (p. 47) the Company Law Review Steering Group originally proposed that the memorandum and articles should be merged to create one single constitutional document. The government disagreed and recommended retaining both the memorandum and articles, and **s 7(1)(a) of the CA 2006** provides that all companies must have a memorandum. However, under the **CA 2006**, the content and importance of the memorandum have been reduced significantly, and it no longer forms a principal component of the company's constitution. Table 4.1 demonstrates clearly the reduced importance of the memorandum under the **CA 2006**.

Table 4.1 The evolution of the memorandum

Companies Act 1985	**Companies Act 2006**
Sections 1(3)(a) and 2 of the CA 1985 (now repealed) provided that the memorandum must state: • if the company is public, • the memorandum must state that the company is public; • the name of the company; • whether the company is to be situated in England and Wales, or in Scotland; • the objects of the company; • whether or not the liability of the members is limited, and the method of limitation, and; • details concerning the company's share capital and the subscribers of the company's first shares.	**Section 8 of the CA 2006** provides that the memorandum must state that the subscribers: • wish to form a company under the Act, and; • agree to become members of the company and, in the case of a company with a share capital, to take at least one share each.

It can therefore be seen that, under the **CA 2006**, all that the memorandum does is to provide an 'historical snapshot' that indicates the company's state of affairs at the time it was created.

The articles of association

With the emasculation of the memorandum, the articles now form a company's principal constitutional document. The articles tend to regulate the internal workings of the company and typically cover issues such as the balance of power between the members and the directors, the conduct of general meetings, and certain issues pertaining to shares and the distribution of assets. If a company chooses to limit its objects, the objects clause will also form part of the articles (the objects clause is discussed later in this chapter at p 53, 'The capacity of a company').

Every company must have a set of articles (**CA 2006, s 18(1)**) and promoters are free to draft their own articles that suit the needs of their particular business requirements, and submit them upon registration. However, drafting articles is a complex and technical task and many promoters (especially promoters of smaller companies) will lack the knowledge required to draft suitable articles. Accordingly, statute has long provided a set of model articles that companies may adopt if they so choose. **The Companies (Model Articles) Regulations 2008** (p. 48) provide model articles for private limited companies limited by shares (found in **Sch 1**), private companies limited by

guarantee (found in **Sch 2**), and public companies (found in **Sch 3**). Unlimited companies, being very rare, are not provided with a set of model articles and will need to draft and register their own articles.

> Looking for extra marks?
>
> Be aware of the differences between the model articles found under the **CA 1985** and the **CA 2006**. Prior Companies Acts only provided model articles for companies limited by shares (these model articles were known as Table A). Conversely, the **2008 Regulations** provide model articles for a wider range of companies.

Where the promoters of a limited company do not submit their own articles upon registration, the applicable model articles will form the company's articles (**CA 2006, s 20(1)**). Even if the promoters do register their own articles, the relevant model articles will still form part of the company's articles, unless its registered articles modify or exclude them (**CA 2006, s 20(1)(b)**). Companies incorporated under prior Companies Acts will not be governed by the new model articles, but can adopt them if they so choose.

> Revision tip
>
> Certain provisions of the **CA 2006** can be modified, or even disapplied, by the articles. The **CA 2006** is silent on many aspects of running a company, preferring to allow the company to determine such aspects via the articles. It is therefore vital that you are aware of what a company's articles state. Where a problem question does not provide details regarding a company's articles, it is reasonable to proceed on the basis that the model articles found in the **2008 Regulations** form the basis of the company's articles. Unfortunately, whilst many students are aware of the provisions of the **CA 2006**, students tend to neglect the provisions of the model articles—this is a major mistake.

Should a dispute arise, the courts may be required to interpret the provisions of the articles in order to resolve the dispute. The courts have stated, on numerous occasions, that 'the articles of association of the company should be regarded as a business document and should be construed so as to give them reasonable business efficacy' (***Holmes v Keyes*** **[1959]**). The courts have even stated that the words of the articles are not to be given their plain and obvious meaning if such an interpretation would produce a commercial absurdity (***Thompson v Goblin Hill Hotels Ltd*** **[2011]**).

Resolutions and agreements affecting the company's constitution

Certain resolutions and agreements will also form part of the company's constitution. These are listed in **s 29 of the CA 2006** and are referred to as 'resolutions and agreements affecting a company's constitution'. However, the list of such resolutions and agreements is much (p. 49) wider than this definition suggests and appears to go beyond agreements and resolutions that affect the company's constitution. For example, **s 29(1)(a)** provides that any special resolution will form part of the company's constitution, even though many special resolutions will involve decisions that have no bearing on the company's constitution.

The constitution as a contract

The courts have long held that a company's articles form a contract between a company and its members, and between the members themselves (**Re Tavarone Mining Co (Pritchard's Case) (1873)**). **Section 33(1) of the CA 2006** expands upon this by stating that:

> The provisions of a company's constitution bind the company and its members to the same extent as if there

were covenants on the part of the company and of each member to observe those provisions.

Accordingly, the company's constitution forms what is known as the 'statutory contract' and imposes obligations upon:

- the company when dealing with its members
- the members when dealing with the company, and
- the members when dealing with each other.

Revision tip

You may come across pre-2006 cases and journal articles that refer to the 's 14 contract'. This is simply another term for the statutory contract and derives from **s 14 of the CA 1985**, which was the predecessor to **s 33 of the CA 2006**.

Breach of certain provisions of the company's constitution may therefore constitute breach of contract, thereby allowing the non-breaching party to commence a personal action and obtain a remedy. However, as will be discussed, not all of the constitution's provisions will amount to terms of the statutory contract.

Before discussing the extent to which the statutory contract can be enforced, it is important for students to realize the ways in which the statutory contract differs from a standard contract.

The statutory contract

The statutory contract created by **s 33** is a highly unusual one and, in several important ways, it differs from a standard contract and is not subject to certain standard contractual rules. Table 4.2 demonstrates the principal differences between a standard contract and the statutory contract.

Table 4.2 Differences between a standard contract and the s 33 statutory contract

	A standard contract	The s 33 statutory contract
Derives binding force from?	Derives its binding force from the agreement between the parties	Derives its binding force from **s 33 of the CA 2006**
Alteration of terms against a party's wishes?	The terms of a standard contract cannot usually be altered against the wishes of the parties	As the articles can be altered by passing a special resolution, the majority can alter the terms of the statutory contract against the wishes of the minority
Enforcement by a third party?	Generally, third parties cannot enforce a standard contract, but can do so where **s 1(1) of the Contracts (Rights of Third Parties) Act 1999** applies	Third parties cannot enforce the statutory contract, and the statutory contract is not subject to **s 1 of the Contracts (Rights of Third Parties) Act 1999**
Action for breach of contract?	If any term of a standard contract is breached, it can give rise to an action for breach of contract	Only those terms of the constitution that relate to membership rights can form the basis for an action for breach of the statutory contract
Rectification of contract?	The courts may be willing to rectify a standard contract if it fails to give effect to the parties' intentions, or if it contains a mistake	The courts will not rectify the statutory contract if it fails to give effect to the parties' intentions, or if it contains a mistake (***Scott v Frank F Scott (London) Ltd*** **[1940]**)
Defeasible on certain grounds?	Standard contracts can be defeated on the grounds of mistake, misrepresentation, duress or undue influence	The statutory contract cannot be defeated on the grounds of mistake, misrepresentation, duress or undue influence (***Bratton Seymour Service Co Ltd v Oxborough*** **[1992]**)

One cardinal rule of contract law that does apply to the statutory contract is the doctrine of privity of contract. The statutory contract is formed between a company and its (p. 50) members–persons not party to the statutory contract (known as 'outsiders') are therefore not permitted to enforce the provisions of the constitution.

Eley v Positive Government Security Life Assurance Co (1876) LR 1 Ex D 88 (CA)

FACTS:

The claimant solicitor drafted the defendant company's articles, which were duly registered. The articles provided that the claimant would act as the company's solicitor and could not be removed unless he engaged in some form of misconduct. Soon thereafter, the company ceased to employ the claimant and engaged another firm of solicitors. The claimant alleged that the company had breached the terms of the articles.

HELD:

The claimant's action failed. The company might very well have breached the articles, but as the claimant was not party to the statutory contract, he could not sue for such a breach.

(p. 51) Revision tip

Section 1(1) of the Contracts (Rights of Third Parties) Act 1999 provides that a third party can enforce a term of a contract if it purports to confer a benefit on him. One might have assumed that a claimant in a similar position to the claimant in ***Eley*** could therefore argue that the term of the articles confers a benefit on him, and so can be enforced by him. However, **s 6(2) of the 1999 Act** provides that **s 1** will not apply to the statutory contract created by **s 33 of the CA 2006**, meaning that the statutory contract cannot be enforced by a third party.

The contract between the company and its members

As the constitution forms a contract between the company and its members, it follows that both parties can enforce compliance with the terms of the constitution against the other. In the following case, the company enforced the constitution against one of its members.

Hickman v Kent or Romney Marsh Sheepbreeders' Association [1915] 1 Ch 881 (Ch)

FACTS:

The articles of the defendant company provided that any dispute between it and a member should be referred to arbitration before any legal proceedings were initiated. The defendant purported to expel one of its members (the claimant) from its organization but, instead of referring the dispute to arbitration, the claimant petitioned the High Court for an injunction restraining his expulsion.

HELD:

The articles formed a contract between the company and its members. The company was therefore permitted to enforce the term of the articles and require disputes to be referred to arbitration. The High Court therefore stayed the legal proceedings initiated by the claimant, and the claimant was subsequently expelled.

A member can enforce compliance of a term of the constitution against the company, as occurred in the following case.

Pender v Lushington (1877) 6 Ch D 70 (Ch)

FACTS:

The company's articles provided that its members would have one vote for every ten shares, up to a maximum of 100 votes. Consequently, members with over 1,000 shares would not have voting power commensurate to their shares. To avoid this, members with over 1,000 shares transferred some of their excess shares to several nominees (including the claimant), thereby unlocking the votes within them. The company's chairman (the defendant) refused to accept the nominees' votes and the claimant alleged that his votes were improperly rejected.

HELD:

The claimant's action succeeded. The shares were properly transferred and registered to the nominees, so

refusing to accept their votes constituted a breach of the articles. The court therefore issued an injunction restraining the rejection of the nominees' votes.

(p. 52) However, it is vital to note that not all the terms of the constitution can be enforced in this way. As Buckley LJ stated in ***Bisgood v Henderson's Transvaal Estates Ltd*** **[1908]**, '[t]he purpose of the [constitution] is to define the position of the shareholder as shareholder, and not to bind him in his capacity as an individual'. It follows that only the terms of the constitution that relate to membership rights will form part of the statutory contract, and members must bring their claim in their capacity as members (case law uses the phrase 'member *qua* member' with *qua* meaning 'in the capacity of').

Beattie v E and F Beattie Ltd [1938] Ch 708 (CA)

FACTS:

The company's articles provided that any disputes between it and its members should be referred to arbitration. A director (who was also a member) was alleged to have improperly drawn a salary without the authorization of the company or its members. The company therefore initiated legal proceedings to recover this payment. The director alleged that, because he was a member, the article provision applied and the dispute should be referred to arbitration. He therefore sought to enforce the provision of the constitution.

HELD:

The director was relying on the articles in his capacity as a director, not in his capacity as a member. Accordingly, the director could not enforce the relevant provision of the articles and the legal proceedings were permitted to go ahead.

Accordingly, provisions of the constitution that relate to the rights of directors will not normally form part of the statutory contract. However, in a certain type of company known as a 'quasi-partnership' (discussed at p 154, 'Quasi-partnerships'), the dividing line between a member and director is blurred and the members will usually expect to be involved in management. In such companies, rights conferred upon directors may also be regarded as membership rights (***Rayfield v Hands*** **[1960]** discussed in the next section).

Revision tip

In problem questions, it is vital that you can determine whether or not a provision of the constitution concerns a membership right. Common membership rights contained in the constitution include:

- the right to attend, speak and vote at general meetings
- the method of counting votes at general meetings
- rights relating to the transfer and transmission of shares
- the right to a dividend, once it has been validly declared
- in the case of a quasi-partnership company, the right to manage the company.

The contract between the members themselves

Just as the constitution forms a contract between the company and its members, so too does it form a contract

amongst the members themselves. Accordingly, a breach of the statutory (p. 53) contract by a member can be enforced by another member, providing that the provision breached concerns a membership right.

Rayfield v Hands [1960] Ch 1 (Ch)

FACTS:

The company's articles provided that, if a member wished to sell his shares, he should inform the directors, who would then purchase the shares between them. The claimant wished to sell his shares and so notified the defendant directors, who then refused to purchase the claimant's shares. The directors were all members of the company, and so the claimant sought an order requiring the directors to purchase his shares.

HELD:

The High Court ordered that the directors should purchase the claimant's shares. As the company was a quasi-partnership, the article provision affected the directors in their capacity as members. Accordingly, the provision concerned a membership right and formed part of the statutory contract.

The capacity of a company

As the company is a legal person, it can enter into contracts in much the same way as natural persons can. However, historically, the company's ability to enter into contracts was subject to a significant limitation. Prior to the passing of the **CA 2006**, all companies were required to state in their memoranda the objects or purposes for which the company was set up (this is known as the 'objects clause'). The objects clause serves to limit the contractual capacity of the company and if a company entered into a contract that was outside the scope of its objects clause, the company would be acting *ultra vires* ('beyond one's powers') and the contract would be void *ab initio* (***Ashbury Railway Carriage and Iron Co Ltd v Riche*** **(1875)**).

This restriction on a company's capacity was introduced to protect persons who provided a company with capital, namely members and creditors. Such persons provided capital on the expectation that the company would pursue the lines of business for which it was set up and would not expend capital on frolics outside the company's stated purposes. The problem was that the rules relating to *ultra vires* were overly complex, technical, and vague and served to harm third parties who had innocently contracted with the company. The *ultra vires* doctrine also served to inhibit a company's ability to diversify into other areas of business that could prove profitable. Accordingly, successive Companies Acts have weakened the *ultra vires* doctrine with the **CA 2006** significantly curtailing its scope, especially in relation to companies incorporated under the **CA 2006** and third parties, for whom the doctrine is now largely irrelevant.

Revision tip

Be prepared to discuss the evolution of the law relating to *ultra vires*. There is no doubt that the **CA 1985** and **CA 2006** have substantially weakened the doctrine of *ultra vires*, but it has not been abolished (despite what other sources might state). Do you think the doctrine of *ultra vires* should be completely abolished?

(p. 54) The abolition of the requirement to include an objects clause

The requirement of an objects clause has been abolished by the **CA 2006** (although companies can still include an objects clause if they so wish) and such companies will accordingly have unrestricted objects (**CA 2006, s 31(1)**). For such companies, the *ultra vires* doctrine will be of little relevance as the company's contractual capacity will not

be limited. This is the default position for companies incorporated under the **CA 2006**. Of course, companies incorporated under previous Companies Acts will still have an objects clause but, as a result of the **CA 2006**'s reforms relating to the memorandum (discussed at p 46, 'The evolution of the corporate constitution'), such an objects clause will now be regarded as forming part of the company's articles and not its memorandum. As the articles can be altered by passing a special resolution (**CA 2006, s 21(1)**), such companies can accordingly delete the objects clause by passing a special resolution to that effect and, in doing so, will acquire unrestricted capacity.

Inclusion/retention of the objects clause

The objects clause and the doctrine of *ultra vires* are still relevant in two instances:

1. Although companies incorporated under the **CA 2006** do not need to include an objects clause in their articles, they may do so if they wish. It is anticipated that very few companies incorporated under the **CA 2006** will include an objects clause.
2. Companies incorporated under prior Companies Acts may decide not to, or may neglect to, remove their objects clause. As regards such companies, the objects clause will serve to limit the directors' authority and the *ultra vires* doctrine will still be of relevance, although, as will be discussed, it has lost much of its force.

As was noted, historically, if a company entered into an *ultra vires* contract, then that contract would be rendered void *ab initio*. Unfortunately, this served to harm the innocent third party who contracted with the company and who often had no idea of the scope of the company's objects clause. This is no longer the case as **s 39(1) of the CA 2006** provides that '[t]he validity of an act done by a company shall not be called into question on the ground of lack of capacity by reason of anything in the company's constitution'.

It may be the case that a transaction is within the capacity of the company, but the director who caused the company to enter into the transaction had no authority to do so. In such a case, the issue is not one of corporate capacity, but of directors' authority. Again, the Act seeks to protect third parties, with **s 40(1) of the CA 2006** stating '[i]n favour of a person dealing with a company in good faith, the power of the directors to bind the company, or authorize others to do so, is deemed to be free of any limitation under the company's constitution.'

The result of **ss 39(1)** and **40(1)** is that if a company or director enters into an *ultra vires* contract with a third party, then the contract cannot be attacked on the ground that it is *ultra vires*. Therefore, from the point of view of a third party, the *ultra vires* doctrine is of little (p. 55) relevance, which is why it is often stated that the **CA 2006** abolishes *ultra vires* externally, because it is of little concern to external third parties.

However, whilst the **CA 2006** may have rendered the *ultra vires* doctrine largely irrelevant to persons outside the company, it remains relevant to persons inside the company for two reasons:

1. If a member of a company discovers that the company is about to enter into an *ultra vires* transaction, the member has a personal right to petition the court for an order preventing the company from entering into the transaction (this right arises from the statutory contract that exists between a company and its members (discussed at p 49, 'The constitution as a contract')). However, this right only arises if a legal obligation has yet to arise (**CA 2006, s 40(4)**)—the right is lost once the company has entered into the contract. In practice, most members will only become aware of a contract once the company has entered into it, and so this right will be of little use.
2. Where the directors of a company cause the company to enter into an *ultra vires* transaction, or where the directors exceed the authority bestowed upon them by the constitution, then they will likely be in breach of the statutory duty to act in accordance with the company's constitution (**CA 2006, s 171(a)**—discussed at p 69, 'Duty to act within the company's powers').

Looking for extra marks?

That an *ultra vires* act can result in a breach of directors' duties demonstrates that this area of company law can overlap with other areas. You will want to be aware of other potential overlaps, including:

- As the constitution forms a contract between the company and its members, acting *ultra vires* might place the company in breach of the statutory contract created by **s 33 of the CA 2006** (discussed at p 49, 'The constitution as a contract').
- As acting *ultra vires* can amount to a breach of duty, the members may be able to bring a derivative claim (discussed at p 139, 'The derivative claim') on behalf of the company against the directors who have acted *ultra vires*.
- If the company acts ***ultra vires*** because it has become impossible for it to fulfil the purposes for which it was set up, it may be wound up on just and equitable grounds (discussed at p 153, 'The petition for winding up').

Alteration of the articles

As a company, or the market within which it operates, evolves, it may become necessary for it to alter its articles. **Section 21(1) of the CA 2006** provides that a company may amend its articles by passing a special resolution and, in certain cases, the courts also have the power to amend the articles. However, it should be noted that the ability to alter the articles is not limitless and both statute and the common law impose restrictions on a company's ability to alter its articles.

Revision tip

(p. 56) The rules relating to the alteration of the articles are also important in relation to the statutory contract formed by the articles as part of the company's constitution. Significantly, **s 21(1)** means that generally only the company can alter the content of the statutory contract (albeit through the members) and some members may be bound by article provisions to which they object.

Statutory restrictions

Statute may limit a company's ability to alter its articles. Examples of such limitations include:

- The ability to alter the articles is limited by the provisions of the Companies Acts (***Allen v Gold Reefs of West Africa Ltd* [1900]**).
- A member is not bound by any change in the articles made after he became a member if the effect of the change is to require him to take or subscribe for more shares than the amount he had at the date of the alteration, unless he expressly agrees in writing to the change (**CA 2006, s 25**).
- In certain situations, statute empowers the court to prohibit a company from altering its articles without the court's permission (e.g. where the members of a public company object to it re-registering as private (**CA 2006, ss 97 and 98(6)**)).

Common law restrictions

Perhaps the most important limitation on a company's ability to alter its articles was laid down by Lindley MR in ***Allen v Gold Reefs of West Africa Ltd* [1900]**, who stated that the power to alter the articles must:

> like all other powers, be exercised subject to those general principles of law and equity which are applicable to all powers conferred on majorities and enabling them to bind minorities. It must be exercised, not only in the manner required by law, but also bona fide for the benefit of the company as a whole …

The test imposed by Lindley MR, whilst flexible enough to grant the court a wide discretion, is rather vague, to the extent that the High Court of Australia described it in one case as 'almost meaningless' (***Peters' American Delicacy***

***Co Ltd v Heath* [1939]**). Accordingly, in the following case, the Court of Appeal aimed to provide some much-needed guidance.

Shuttleworth v Cox Brothers & Co (Maidenhead) Ltd [1927] 2 KB 9 (CA)

FACTS:

The company's articles provided that its directors (one of whom was the claimant) would hold office for as long as they wished, unless they became disqualified by virtue of one of **(p. 57)** six specified events. The claimant engaged in a financial irregularity, but it did not fall within one of the six specified events. The other directors therefore used their shares to pass a special resolution altering the articles by adding a seventh event, namely that a director must resign if all the other directors required him to. Following the alteration, the claimant's co-directors demanded his resignation. The claimant challenged the alteration.

HELD:

The test imposed by Lindley MR is predominantly subjective, meaning that if the majority shareholders honestly believed that the alteration was for the company's benefit as a whole, then the alteration would be valid, even if the court disagrees with the majority's assessment. On this basis, the Court held that the alteration was valid, as the other directors did believe that it was for the company's benefit. The Court did, however, impose an objective requirement, namely that an alteration would not be valid if 'no reasonable man could consider it for the benefit of the company'.

It is therefore apparent that a minority shareholder who wishes to challenge an alteration on this ground will face a difficult task. As our system of company law is based heavily on the principle of majority rule, the courts are reluctant to invalidate alterations of the articles, as the following case demonstrates.

Greenhalgh v Arderne Cinemas Ltd [1951] Ch 286 (CA)

FACTS:

The company's articles provided that a shareholder could not sell his shares directly to an outsider if an existing shareholder was willing to purchase them. The company's managing director was also its majority shareholder and he wished to sell his shares to an outsider. Accordingly, in his capacity as majority shareholder, he altered the articles to permit a shareholder to sell his shares to an outsider, without first offering them to an existing shareholder, providing that an ordinary resolution was passed (which would be a certainty given that he was the majority shareholder). A minority shareholder challenged the alteration.

HELD:

The phrase 'the company as a whole' meant the shareholders as a body and the court should take the case of a hypothetical member and ask whether the alteration was for his benefit. On this basis, if an outsider was to wish to purchase the shares of a hypothetical member, it might well be in that member's benefit to sell his shares directly to an outsider. Further, the advantage obtained by the majority shareholder was also obtained by all the other shareholders, so the alteration was not discriminatory. Accordingly, the alteration was deemed valid.

Entrenched article provisions

A company cannot make its articles unalterable (***Walker v London Tramways Co* (1879)**). However, the **CA 2006** introduced the ability to entrench article provisions, thereby making them more difficult to alter (**s 22 of the CA 2006**). This could be done by requiring additional conditions to be met (e.g. by requiring unanimity instead of the normal special resolution) or by imposing restrictive procedures to be adhered to (e.g. by requiring the **(p. 58)** alteration to be approved of by certain specified members). In order to prevent abuse, the Act does impose several safeguards, including:

- Entrenchment will not prevent alteration where all of the members agree to an alteration, or where the court orders an alteration be made.
- If a company wishes to entrench an article provision after the company has been formed, it can only do so with the agreement of all the members of the company.

Key cases

Case	Facts	Principle
Allen v Gold Reefs of West Africa Ltd **[1900]** 1 Ch 656 (CA)	The company's articles granted it a lien over partly paid shares. The articles were amended to extend the lien to cover fully paid-up shares.	An alteration to the articles will only be valid if it is bona fide for the benefit of the company as a whole.
Beattie v E and F Beattie Ltd **[1938]** Ch 708 (CA)	A company initiated legal proceedings against one of its directors. The director sought to rely on a provision of the articles, which stated that disputes would first be referred to arbitration.	A member seeking to enforce the constitution must be acting in his capacity as a member. Constitution provisions that do not relate to membership rights will not normally form part of the statutory contract.
Eley v Positive Government Security Life Assurance Co **(1876)** LR 1 Ex D 88 (CA)	The company's solicitor attempted to enforce a provision in the company's articles in order to prevent his removal.	Outsiders are not party to the statutory contract created by the constitution and so cannot enforce its provisions.
Greenhalgh v Arderne Cinemas Ltd **[1951]** Ch 286 (CA)	The company's managing director and majority shareholder sought to alter the articles to remove the members' pre-emption rights, and allow them to sell shares to an outsider, without first offering them to existing members.	The phrase 'the company as a whole' refers to the shareholders as a body. The court should ask whether or not the alteration was for the benefit of a hypothetical member.
Hickman v Kent or Romney March Sheepbreeders' Association **[1915]** 1 Ch 881 (Ch)	A member initiated legal proceedings against the company, even though the company's articles stated that disputes would first be referred to arbitration.	The constitution forms a contract between the company and its members. Accordingly, the company could enforce the constitution and the legal proceedings were stayed.

***Pender v Lushington* (1877)** 6 Ch D 70 (Ch)	The articles limited the voting power of members who held a large amount of shares. These members transferred their shares to nominees in order to circumvent the limitation. The company's chairman rejected the nominees' votes.	The shares were validly transferred. Therefore, the company had no right to reject the nominees' votes. The nominee members were therefore permitted to enforce the constitution against the company.
***Rayfield v Hands* [1960]** Ch 1 (Ch)	The articles provided that if a member wished to sell his shares, the directors would purchase them. The directors refused to purchase a member's shares.	The constitution forms a contract between the members themselves, which can be enforced by a member, providing that the provision breached concerns a membership right. In quasi-partnership companies, rights conferred upon the directors will likely be regarded as membership rights.
***Shuttleworth v Cox Brothers & Co (Maidenhead) Ltd* [1927]** 2 KB 9 (CA)	The company wished to alter its articles in order to remove a director who had engaged in financial irregularities.	The test imposed in *Allen* was primarily subjective, although an alteration would not be valid if no reasonable man could consider it to be for the benefit of the company.

(p. 59) Key debates

Topic	**The constitution as a contract**
Author/Academic	Robert R Drury
Viewpoint	Reviews a number of academic viewpoints regarding a shareholder's ability to enforce the constitution..
Source	'The Relative Nature of a Shareholder's Right to Enforce the Company Contract' [1986] CLJ 219
Topic	**Alteration of the articles**
Author/Academic	FG Rixon
Viewpoint	Provides an in-depth analysis of the power to alter the articles and examines the limitations upon this power. It also discusses what remedies are available to a person who wishes to challenge an alteration of the articles.
Source	'Competing Interests and Conflicting Principles: An Examination of the Power of Alteration of Articles of Association' (1986) 49 MLR 446

Essay question

> 'The contract created by the company's constitution is a highly unusual one, but the ability to enforce the constitution provides the members with a powerful source of protection.'

Discuss.

See the Outline Answers section in the end matter for help with this question.

Problem question

The objects clause of Covenant Ltd, a company incorporated in 2009, provide that the business of the company is to design and create websites for charities. The company's two directors, Mike and Paul, own 25 per cent of the company's shares, with the remaining shares split equally between three private investors (Ceri, Jo, and Deborah). Ceri, Jo, and Deborah are concerned that the company could become burdened by debt, so they pass a special resolution directing the board not to borrow any capital unless first approved by an ordinary resolution.

Covenant's business prospects are not good and the directors believe that the company will need an injection of capital if it is to continue trading. Ceri argues that the company should expand its business by designing and creating websites for any corporate client, not just charities, and if the directors agree to this, she will lend the company £100,000. A meeting is convened, but Jo and Deborah do not believe that the company should take on more debt, although Jo does believe that the company should not limit its client base to charities. Accordingly, Jo and Deborah vote against the loan. Believing the loan to be in the interests of the company, the board accepts the loan and use it to expand their business by taking on corporate clients. The expansion of business is a success and Covenant begins to make a profit. However, Deborah believes that the company should stick to its original aim of only designing websites for charities, and argues that, in not doing so, it is acting outside the scope of its constitution. The board, Ceri and Jo become tired of Deborah's complaints and insert a provision in the articles, which provides the majority with the power to compulsorily purchase the shares of any minority member. They exercise this power and expel Deborah as a member.

Advise Deborah.

Online Resource Centre

To see an outline answer to this question log on to www.oxfordtextbooks.co.uk/orc/concentrate/

Law Trove

Company Law Concentrate: Law Revision and Study Guide (3rd edn)

Lee Roach

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5. Directors

Chapter: (p. 61) 5. Directors
Author(s): Lee Roach
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Key facts

- Every private company must have at least one director and every public company must have at least two directors.
- The power to manage the company is initially vested in the members, but is usually delegated to the directors by the articles.
- Directors' duties are now found in the Companies Act 2006, which provides for seven general duties that directors owe to the company.
- The general duties are based on prior common law duties, so pre-2006 case law will remain relevant.
- Certain types of transaction involving directors will only be valid if authorized by a resolution of the members.
- A director's term of office can terminate in several ways including resignation, retirement, or removal. Additionally, the courts can disqualify a person from acting as director.

(p. 62) **The definition of 'director'**

A company may be run by persons who call themselves 'governors' or 'managers' and, increasingly, persons not involved in management at board level are called 'directors'. Are such persons actually directors?

> Revision tip
>
> Many provisions of the **CA 2006** apply solely to directors. It may therefore be crucial, especially in problem questions, that you correctly determine whether or not the persons concerned are actually directors. Do not forget that a person may legally be regarded as a director, even though he has not been formally appointed as such.

The **CA 2006** does not define what a director is. Rather, it states who is included within the office of director with **s 250 of the CA 2006** providing that a director 'includes any person occupying the position of director, by whatever name called'. This broad definition will cover those who have been validly appointed to the office of director (known as *de jure* ('in law') directors), but will also cover persons who have not been validly appointed, but who act as directors (known as *de facto* ('in fact') directors). *De facto* directors, although not validly appointed, are therefore directors under the Act and subject to the relevant provisions (e.g. the general duties discussed at p 67, 'Directors' duties').

> Looking for extra marks?
>
> There is little doubt that the courts have, over time, notably expanded the types of person who can be classified as a *de facto* director. For an account of the history of the law relating to *de facto* directors and how the breadth of the office has been expanded, see the judgment of Lord Collins in ***Commissioners of HM Revenue and Customs v Holland*** **[2010]**, especially [58]–[93].

A director can be a natural or legal person, but every company must have at least one director who is a natural person (**CA 2006, s 155(1)**).

Shadow directors

A person who has neither been appointed a director, nor acts as a director, may be treated as a director if he is 'a person in accordance with whose directions or instructions the directors of the company are accustomed to act' (**CA 2006, s 251(1)**), other than where that advice is given in a professional capacity (**CA 2006, s 251(2)**). Such a person is known as a 'shadow director'.

> Revision tip
>
> It is important that you are aware of how to identify a shadow director as not all provisions in the **CA 2006** that apply to directors will apply to shadow directors. Often, the **CA 2006** will expressly (p. 63) state that a particular duty or obligation is imposed upon shadow directors. For example, in relation to the rules concerning directorial transactions that require member approval (discussed at p 79, 'Transactions requiring approval of the members'), a shadow director is to be treated as a director (**CA 2006, s 223(1)**).

In practice, determining whether a person is a shadow director can be difficult. Accordingly, in ***Secretary of State for Trade and Industry v Deverell*** **[2001]** and ***Ultraframe (UK) Ltd v Fielding*** **[2005]**, the courts sought to establish

guidance, as follows:

- it is not necessary for the shadow director to give directions/instructions over the whole field of the company's activities;
- whether a communication amounts to a direction/instruction is to be determined objectively;
- it is not necessary to show that the *de jure* directors acted in a subservient manner;
- it is insufficient that some of the *de jure* directors follow the directions/instructions—it must be demonstrated that a governing majority of the board were accustomed to following the directions/instructions;
- as the *de jure* directors must be *accustomed* to the directions/instructions, it follows that, initially, a person who gives directions/instructions will not be a shadow director;
- the mere giving of directions/instructions is insufficient—it must also be shown that the directors acted on such directions/instructions.

Looking for extra marks?

Be aware of areas where the law lacks clarity as these areas are prime candidates for essay type questions in assessments. For example, it is clear that the general duties imposed upon directors by the **CA 2006** do not apply to shadow directors, but there is uncertainty regarding what duties shadow directors are subject to. Lewison J in ***Ultraframe*** stated that a shadow director did owe duties to the company, but that, in many cases, the relationship that a shadow director has with the company would not be enough to impose upon a shadow director fiduciary duties (e.g. a duty of loyalty). Lewison J's statement was strongly criticized (see e.g. DD Prentice and Jennifer Payne, 'Directors' Fiduciary Duties' (2006) 122 LQR 558, who stated that 'it would be odd if shadow directors were not subject to the full panoply of fiduciary duties in the same was as de facto directors') and a number of academics have argued that the law should treat shadow directors and *de facto* directors in the same way (especially since in ***Commissioners of HM Revenue and Customs v Holland*** **[2010]**, the Supreme Court stated that a person could be both a *de facto* and shadow director). The relevant comments of Lewison J have also been doubted judicially in the recent case of ***Vivendi SA v Richards*** **[2013]**, where Newey J stated that 'my own view is that Ultraframe understates the extent to which shadow directors owe fiduciary duties. It seems to me that a shadow director will typically owe such duties in relation at least to the directions or instructions that he gives to the de jure directors'. For a discussion on the law in this area, see Stephen Griffin, 'Confusion Surrounding the Characteristics, Identification and Liability of a Shadow Director' (2011) 24 Insolv Int 44 (who argues that the distinction between shadow directors and *de facto* directors should be abolished) and Susan Watson, 'The Nature of Shadow Directorship: Ad Hoc Statutory Intervention or Core Company Law Principle?' [2006] JBL 763 (who argues that the distinction should be maintained).

(p. 64) Appointment

Every private company must have at least one director and every public company must have at least two directors (**CA 2006, s 154**). The proposed directors of the company will become its directors officially upon successful incorporation. Thereafter, the power to appoint directors is a matter for the articles, but where the articles are silent on this issue, the power to appoint directors is vested in the members (***Worcester Corsetry Ltd v Witting*** **[1936]**) and is usually exercised by passing an ordinary resolution.

The model articles for private companies limited by shares and the model articles for public companies provide that directors may be appointed by an ordinary resolution of the members, or by a decision of the directors.

Looking for extra marks?

Should you be required to discuss the appointment of directors, it is worth noting that **Principle B.2.1 of the UK Corporate Governance Code** recommends that the appointment of directors should be led by a nomination committee, consisting predominantly of independent non-executive directors. These committees were introduced to combat the perception of the 'old boys' network' that many believed operated in larger public companies.

Whilst generally anyone can act as a director, certain types of person are prohibited by statute from being appointed (e.g. a company's auditor cannot be appointed as its director (**CA 2006, s 1214**)).

Once appointed, directors may be required to be periodically re-elected by the members in order to remain in office, with **Principle B.7 of the UK Corporate Governance Code** recommending that all directors should submit to re-election at regular intervals. Controversially, the 2010 update to the Code recommended that all directors of FTSE 350 companies should face re-election every year, with many directors believing that this may lead to a short-termist approach and less stable boards. In all other cases, re-election should take place at intervals of no longer than three years. The model articles for public companies also establish rules that require a director to submit himself for re-election at least every three years.

Looking for extra marks?

The appointment of directors is currently a prominent topic, largely due to recent attempts to increase diversity within UK boardrooms, especially gender diversity. Lord Davies's 2011 report entitled *Women on Boards* recommends that FTSE 100 companies should aim for a minimum of 25 per cent female representation by 2015, and since the publication of the report, the number of women on FTSE 100 boards has indeed increased (although Lord Davies's follow-up report in 2013 expressed concern that the majority of new female appointees have not been appointed as executives, but as non-executive directors). Following Lord Davies's report, the **UK Corporate Governance Code** was amended to provide that companies should have regard to diversity when appointing directors, and that the annual report should set out the board's appointment policy in relation to diversity, including gender. Whilst there is little doubt that increased diversity **(p. 65)** can bring substantial benefits, there is strong disagreement over how greater diversity can be achieved. The UK clearly favours a voluntary approach but, in November 2013, the European Parliament passed a draft law that will, if passed by the EU Member States, require at least 40% of non-executive directors of listed companies to be women. Unsurprisingly, the UK (and several other Member States) have indicated they will oppose this quota. It is clear that gender diversity within the boardroom is a highly prominent and developing topic and one that you should stay abreast of, but should the diversity debate be focusing on diversity in general, and not just gender diversity?

The board of directors

Collectively, the directors of a company are referred to as the 'board'. Much of a company's power is concentrated in its board, which exercises its powers via board meetings (not to be confused with general meetings of the company). The procedures relating to board meetings are a matter for the company's articles and decisions of directors are only valid if made at a board meeting, unless all the directors agree to, or acquiesce to, a decision (***Charterhouse Investment Trust Ltd v Tempest Diesels Ltd* [1986]**). The law does not require that all the directors must be present at a board meeting, but decisions of board meetings will only be valid if a quorum can be obtained. The model articles set the quorum at two (unless the company is private and only has one director, in which case, it will be one), and decisions taken at a meeting that lacks a quorum (such meetings are said to be 'inquorate') are invalid.

Powers of management

A company, being a legal person, can only be run through human intermediaries, which leads us to ask, who has the power to run the company? The power to run a company is initially vested in its members. However, in all but the

smallest private companies (where the directors and members are usually the same persons), it is impractical for the members to exercise day-to-day control over the company's affairs. Accordingly, the members' powers are usually delegated to the company's directors via the articles, but who has the ultimate right to manage the company: the members or the directors?

The directors have only such power as is delegated to them by the members, with most companies having a provision in their articles that delegates day-to-day control of the company to the directors. In such cases, the power to manage is vested in the directors and the members have no right to interfere in the company's management, unless such a power has been reserved to the members via the articles or statute.

Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame [1906] 2 Ch 34 (CA)

FACTS:

The articles of a company conferred general powers of management upon its directors and provided that they could sell any property of the company on such terms as they deemed fit. **(p. 66)** The members passed an ordinary resolution resolving to sell the company's assets and undertakings, but the directors did not believe that such a sale was in the interests of the company and so refused to proceed with the sale.

HELD:

The right to manage the company and the right to determine which property to sell was vested in the directors. Accordingly, the directors were not required to comply with the resolution, unless the articles so provided.

Article 3 of both the model articles for private companies limited by shares and the model articles for public companies provides that '[s]ubject to the articles, the directors of the company are responsible for the management of the company's business, for which purpose they may exercise all the powers of the company'. Clearly, this vests considerable powers in the directors but, as it is 'subject to the articles', provisions can be inserted into the articles that affect the balance of power, as the following case demonstrates.

Salmon v Quin & Axtens Ltd [1909] AC 442 (HL)

FACTS:

The company's articles conferred general powers of management upon the directors, but such powers were subject to the articles. Article 80 provided that decisions of the directors relating to the acquisition of certain properties would be invalid if two named members were to dissent. The directors decided to acquire such property, but the two named members vetoed the decision. A general meeting was called and the other members passed an ordinary resolution resolving to acquire the property. The two members who vetoed the decision sought an injunction to restrain the property acquisition.

HELD:

Whilst the directors had a general power of management, it was subject to the articles. Accordingly, the veto exercised by the named members was valid and the company could not override it by passing an ordinary resolution. The House therefore granted an injunction restraining the acquisition.

In both ***Automatic Self-Cleansing*** and ***Salmon***, ordinary resolutions passed by the members could not affect the powers conferred by the articles, as this would permit the members to alter the articles indirectly by ordinary

resolution and, as noted at p 55, 'Alteration of the articles', an alteration of the articles requires a special resolution. It follows from this that a direction from the members passed by special resolution should be valid, and this is reflected in **art 4(1)** of the model articles, which states that '[t]he members may, by special resolution, direct the directors to take, or refrain from taking, specified action'. Accordingly, whilst general power is vested in the directors, the members retain a specific statutory supervisory power exercisable by passing a special resolution (providing that **art 4(1)** forms part of the company's articles).

Finally, it should be noted that where the directors are unable or unwilling to exercise the powers of management conferred by the articles, then the general powers of management revert back to the members (***Barron v Potter* [1914]**).

(p. 67) Revision tip

Exam questions discussing the powers of directors, especially in relation to the powers of members, are popular. Be prepared to discuss the powers of management of the directors and the balance of power within a company. In problem questions, be mindful of companies with article provisions that affect the balance of power between the directors and the members.

Directors' duties

The problem with having such a concentration of power vested in the directors is that they might be tempted to use their powers to benefit themselves, or to engage in acts that are not in the company's interests. The law aims to discourage such behaviour in several ways, with the principal method being the imposition upon directors of a number of legal duties.

Revision tip

Questions on directors' duties arise commonly in exams (in fact, it would be highly unusual for directors' duties to not feature in an exam). Essays tend to focus on the effectiveness of the duties (or the effectiveness of a single duty) or require a discussion of how the **CA 2006** has reformed directors' duties (therefore, you should pay particular attention to those duties that have been substantially reformed by the 2006 Act, such as the duty found in **s 172**). Problem questions usually require you to discuss whether or not the directors involved have committed a breach of their duties. Given the pervasiveness of directors' duties, it is common for directors' duties to feature in problem questions concerning other areas of company law.

Codification

Historically, the duties of directors were set out in a mass of case law spanning several centuries that was based on the common law of negligence and equitable duties analogous to those imposed on trustees. The result was that the law was unclear, inaccessible, and out of date, and, in order to obtain a clear understanding of the duties imposed upon them, directors would need to read through this mass of case law and statute or obtain costly legal advice. It was therefore decided that the law relating **(p. 68)** to directors' duties should be collected and set out in statute (this is known as '**codification**'), thereby providing an authoritative, accessible, and more modern statement of directors' duties. Accordingly, the common law duties have been abolished (although as is discussed, the case law remains very relevant) and replaced by the duties found in **ss 171–177 of the CA 2006**. The law relating to director transactions that require member approval has also been restated in **ss 188–226**.

Looking for extra marks?

An exam question may require you to discuss whether or not codification was a worthwhile reform. For a detailed yet clear discussion of the advantages and disadvantages of codifying the law relating to directors' duties, see the Law Commission Report entitled *Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Directors' Duties* (Law Com No 261, 1999) and the consultation documents of the Company Law Review Steering Group entitled *Developing the Framework* (2000) and *Completing the Structure* (2000).

Figure **5.1** sets out the duties as imposed by the **CA 2006**.

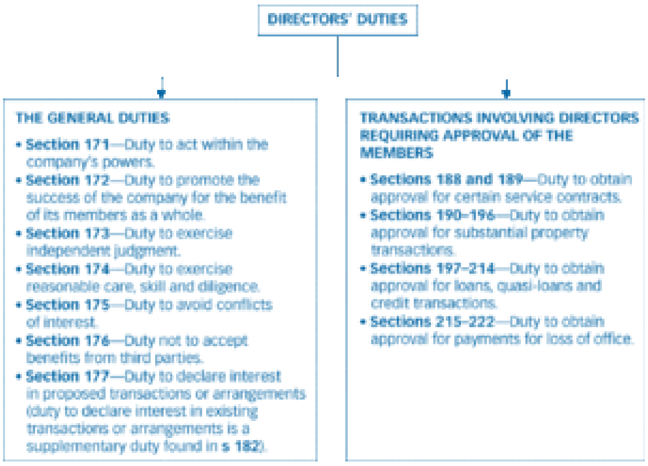

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Figure 5.1
Directors' duties

The general duties

The **CA 2006** refers to the newly codified duties as the 'general duties' and provides that they are 'based on certain common law (p. 69) rules and equitable principles as they apply in relation to directors' (**CA 2006, s 170(3)**). This makes clear the fact that codification has not radically altered the content of the duties, but has merely restated them in a more appropriate manner (although notable reforms have been made). The lack of change ensures that the significant and authoritative pre-2006 body of case law that exists will remain relevant—a fact backed up by **s 170(4)**, which provides that 'regard shall be had to the corresponding common law rules and equitable principles in interpreting and applying the general duties'. Accordingly, you should not ignore case law simply because it was decided under the common law duties, especially as the **CA 2006** does not specify what remedies can be ordered for breach of the various duties, but simply provides that the remedies under the common law will continue to apply to their statutory successors (**CA 2006, s 178(1)**).

Looking for extra marks?

It would not have been unduly burdensome for Parliament to set out in the **CA 2006** what remedies are available for breach of the general duties, but it chose not to. Setting out the remedies would have made the law clearer and more accessible, but by preserving the remedies already set out in case law, the law remains flexible as the courts can continue to develop existing case law in a way that would not have been possible if the remedies had been set out in statute. By not setting the remedies out in statute, do you think the statutory statement of directors' duties is incomplete or lacks the clarity that it should have had?

As under the common law, the directors owe their duties to the company (**CA 2006, s 170(1)**) and do not generally owe their duties to members, creditors, employees, or anyone else. The result is that generally only the company itself can commence proceedings to remedy a breach of the directors' duties, although in some cases the members might be able to commence proceedings via a derivative claim (discussed at p 139, 'The derivative claim').

Sections 171–177 of the CA 2006 provide for seven general duties (with a supplementary duty found in **s 182**) and you should ensure that you are familiar with them all.

Duty to act within the company's powers

The first general duty can be found in **s 171** and is an amalgam of two prior common law duties, namely:

(a) the duty to act in accordance with the company's constitution, and
(b) the duty to exercise powers only for the purposes for which they are conferred.

As is discussed at p 53, 'The capacity of a company', the powers of the company are predominantly set out in the company's articles, and the default position is that companies created under the **CA 2006** will have unrestricted objects. However, it is common for companies to impose some form of limitation on the directors' power and directors who breach such limitations (e.g. by acting *ultra vires*) will likely breach the duty found in **s 171(a)**. A director who breaches the duty found in **s 171(a)** is liable to compensate the company for any loss sustained due to the breach.

Whilst the duty to act in accordance with the company's constitution is important, it is the second strand of the **s 171** duty that is arguably the more important. This strand is based on the common law 'proper purpose' doctrine and provides that directors must exercise their powers only for the purposes for which they are conferred.

(p. 70) Revision tip

The duty found in **s 171(b)** is a wide-ranging one and applies to all the powers of a director. However, much of the case law in relation to the proper purpose doctrine concerns the directors' power to allot shares (discussed at p 119, 'The power to allot shares'), or the extent to which the directors can act to frustrate a takeover bid. Should you face a problem question involving either of these situations, do not forget to consider whether or not the directors have used their powers for a proper purpose. If the directors have acted for the dominant purpose of maintaining themselves in office, manipulating voting power or benefiting themselves financially, the duty will likely have been breached.

The problem that arises is that directors will often exercise their powers for several purposes, some of which are proper and others improper. The approach taken by the courts in such instances was established in the following case.

Howard Smith Ltd v Ampol Petroleum Ltd [1974] AC 821 (PC)

FACTS:

The claimant controlled 55 per cent of shares in company *X*, and wanted to take it over. The defendant made a rival bid which was rejected by *X*'s majority shareholder, namely the claimant. The directors of *X* favoured the defendant's bid, but this bid could not succeed so long as the claimant was the majority shareholder. Accordingly, the directors of *X* issued a batch of shares and allotted them to the defendant. The purpose of the share issue was (i) to raise capital to purchase a new oil tanker and (ii) to reduce the claimant's shareholding to 37 per cent, thereby preventing it from rejecting the defendant's bid. The claimant alleged that the issue of shares was for an improper purpose.

HELD:

Where the directors exercise their powers for several purposes, the court should objectively determine what is the dominant purpose. If the dominant purpose is proper, no breach of duty will occur, even though subservient improper purposes might exist, and vice versa. Applying this, the court held that the dominant purpose of the share issue was to relegate the claimant to the status of minority shareholder. This was unsurprisingly deemed to be an improper purpose, and so the directors of *X* had breached their duty to act for a proper purpose.

Looking for extra marks?

Howard Smith is an important case, especially given that the proper purpose doctrine permeates all of the powers exercisable by the directors. For a more detailed discussion of the case and the approach established by the court, see John H Farrar, 'Abuse of Power by Directors' (1974) 33 CLJ 221.

Where directors act for an improper purpose, such acts are voidable at the company's instance and the directors in question may be required to compensate the company for any loss sustained. However, both consequences can be avoided if the members ratify the breach of duty (***Hogg v Cramphorn* [1967]**).

(p. 71) Duty to promote the success of the company

The second general duty can be found in **s 172** and is a reformulation of the common law duty to act *bona fide* in the interests of the company (***Re Smith and Fawcett Ltd* [1942]**). **Section 172** provides that a director must 'act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole'.

Revision tip

The duty found in **s 172** is arguably the most important general duty and is the duty that has undergone most change as a result of codification. Be prepared to discuss how the **s 172** duty differs from its common law predecessor, the rationale behind the changes, and the extent to which the reforms encourage a more stakeholder-orientated approach. Numerous articles have been written on **s 172**, so there is a wealth of academic analysis available.

The wording of **s 172** clearly indicates that the duty is subjective, meaning that what matters is what the directors honestly believed would promote the success of the company. It is not the court's place to substitute its views for those of the directors. Accordingly, providing that the decision of the directors was honest, it does not matter that it was unreasonable (***Extrasure Travel Insurance Ltd v Scattergood* [2003]**). However, there are limits on the subjectivity of the duty. In ***Hutton v West Cork Rly Co* (1883)**, Bowen LJ stated that if the duty was entirely subjective then 'you might have a lunatic conducting the affairs of the company, and paying away its money with both hands in a manner perfectly *bona fide* yet perfectly irrational'. Accordingly, the courts will closely examine the evidence and try to determine whether or not the directors honestly believed that their actions were designed to promote the success of the company for the benefit of its members. Where a director's act or omission causes the company harm, the court will not be easily persuaded that the director honestly believed his actions to be in the company's interest (***Regentcrest plc v Cohen* [2001]**). There is little doubt that where the evidence does not provide a conclusive answer, the courts will temper the subjective test with an objective examination, but the test still remains primarily subjective.

Revision tip

What if the director in question has not considered whether his act or omission will promote the success of the company for the benefit of its members? In such a case, a subjective test will be of little use. In ***Charterbridge Corporation Ltd v Lloyds Bank Ltd*** **[1970]**, Pennycuick J stated that, in such cases, the proper test would be 'whether an intelligent and honest man in the position of the director of the company concerned, could … have reasonably believed that the transaction was for the benefit of the company'. Accordingly, in such cases, the duty becomes primarily objective.

The phrase 'promote the success of the company for the benefit of its members' is interesting, but the Act does not indicate how the success of the company is to be measured. Parliamentary debate in Hansard indicates that success should be measured in terms of long-term shareholder value. In many cases, the interests of the company and its members (p. 72) will align, so no problem arises. However, this will not always be the case and, in some cases, the interests of the company and its members may conflict. The following case indicates that where the interests of the company and part of its membership conflict, preference should be given to the interests of the company. Whether the directors can favour the company over the members as a whole is unclear.

Mutual Life Insurance Co of New York v Rank Organisation Ltd [1985] BCLC 11 (Ch)

FACTS:

The defendant company issued 20 million shares, half of which were made available, on preferential terms, to existing shareholders. However, existing shareholders in the USA and Canada were excluded from this offer on the ground that to include them would require the company to comply with complex legislation in those countries, which would prove costly and therefore would not be in the company's interests. The claimant (an organization acting on behalf of a number of the defendant's American shareholders) objected to the exclusion.

HELD:

The directors of the defendant had exercised their powers in the interest of the company, and so, in favouring the company over some part of the shareholders, had not breached their duty.

Do not assume that the various duties imposed upon directors operate in isolation. The duty imposed by **s 172** is a broad one and can impact upon other duties. In ***Item Software (UK) Ltd v Fassihi*** **[2004]**, the court held that a director who breaches a fiduciary duty will be required to disclose that breach of duty to the company if the duty to act in the interests of the company requires such disclosure. The court in ***British Midland Tool Ltd v Midland International Tooling Ltd*** **[2003]** held that this obligation extends to disclosing the breaches of fellow directors. In keeping with the subjective nature of this duty, the key factor is whether the director honestly considers that it is in the company's interest to know about the breach (***Fulham Football Club (1987) Ltd v Tigana*** **[2004]**). Clearly, disclosure of a breach of duty will usually be in the company's interests and a failure to do so might result in a breach of **s 172**, in addition to a breach of the original duty. In ***GHLM Trading Ltd v Maroo*** **[2012]**, Newey J went further and stated, *obiter*, that this duty of disclosure could extend to disclosing matters other than wrongdoing and that disclosure might be justified to a person other than a board member. A failure to disclose can result in a loss of employment benefits (e.g. share options, or certain employment rights) and may provide a justification for summary dismissal (***Tesco Stores Ltd v Pook*** **[2003]**).

Looking for extra marks?

The obligation upon a director to disclose his own breaches of duty and those of his fellow directors is a controversial and developing area of the law. For more, see Alan Berg, 'Fiduciary Duties: A Director's Duty to Disclose his Own Misconduct' (2005) 121 LQR 213.

A common criticism levelled at the previous common law duty was that it overly prioritized the interests of members and failed to acknowledge the effect that the directors' actions **(p. 73)** can have on other constituents, such as employees, creditors or the environment. To remedy this, the Company Law Review Steering Group recommended the adoption of the 'enlightened shareholder value approach', under which the interests of the members would retain priority, but the directors would also be required to take into account wider factors.

Looking for extra marks?

The other approach considered by the Company Law Review Steering Group was the 'pluralist approach,' which provided that the members' interests would not have priority and the company would be required to equally balance the interests of all stakeholders. In a discussion of **s 172**, be prepared to discuss why the Company Law Review Steering Group rejected the pluralist approach (on this, see the consultation document entitled *The Strategic Framework* (1999)), and whether you think it was right to do so.

Parliament accepted the Company Law Review Steering Group's recommendation and so **s 172(1)** provides that when directors are considering what would promote the success of the company for the benefit of its members, regard must be had (amongst other things) to:

- the likely consequences of any decision in the long-term. The White Paper *Company Law Reform* (Cm 6456, 2005) recommended that the directors should be required to consider the short-term and long-term impact of their actions—that Parliament chose to remove the reference to short-term impacts clearly indicates that it considers the long-term well-being of the company to be more important. This is noteworthy as a common criticism of our system of company law was that it took an overly short-term approach
- the interests of the company's employees
- the need to foster the company's business relationships with suppliers, customers, and others
- the impact of the company's operation on the community and the environment
- the desirability of the company maintaining a reputation for high standards of business conduct, and
- the need to act fairly as between members of the company.

Looking for extra marks?

To what extent does **s 172** provide a more stakeholder-friendly duty? The non-exhaustive list of factors contained in **s 172(1)** is welcome, but the directors are only required to 'have regard' to these factors. The phrase 'have regard' was used in **s 309 of the CA 1985**, which imposed a duty on directors to have regard to the interests of employees, but it was universally acknowledged that this duty was extremely weak. What **s 172** does not clearly state is whether the directors are free to subordinate the interests of the members to the interests stated in **s 172(1)**, although Lord Goldsmith, a former Attorney General, stated in Hansard that the list of factors in **s 172(1)** was subordinate to the overall duty imposed by **s 172**. For an excellent discussion of the common law predecessor to **s 172**, and the extent to which **s 172** changes the law, see David Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP 2012) ch 10.

(p. 74) Where a director acts in a manner that breaches **s 172**, that act is voidable at the company's instance.

Where the act also causes the company to sustain loss, those directors in breach will be required to indemnify the company for such loss. Of course, as the duty is owed to the company, the company will be the proper claimant unless the members can bring a derivative claim. Given the breadth of the duty found in **s 172**, it can be difficult for the members to determine whether or not the directors have breached the **s 172** duty. Accordingly, a new **s 414A** has been inserted into the **CA 2006**, which places a duty on the directors to prepare a strategic report for each financial year. **Section 414C** goes on to state that '[t]he purpose of the strategic report is to inform members of the company and help them assess how the directors have performed their duty under section 172 …' **Section 414C** then goes on to state what information must be contained within the strategic report. It remains to be seen the impact that the strategic report will have upon how directors approach the **s 172** duty.

Duty to exercise independent judgment

The third general duty, namely the duty to exercise independent judgment found in **s 173**, is a reformulation and encapsulation of the common law duty placed upon directors not to fetter their discretion when exercising their powers. However, this duty was not absolute and the courts recognized that directors could fetter their discretion and bind themselves to act in a certain way if they *bona fide* believed such an action to be in the interests of the company (***Fulham Football Club Ltd v Cabra Estates plc* [1992]**). This principle has been preserved by **s 173(2)(a)** which provides that the duty to exercise independent judgment will not be breached where the directors act 'in accordance with an agreement duly entered into by the company that restricts the future exercise of discretion by its directors'. Additionally, **s 173(2)(b)** provides that the duty will not be breached where the director acts in a way that is authorized by the company's constitution.

Any agreement entered into that contravenes **s 173** will be voidable at the company's instance. Any directors in breach will also be required to account for any gains made and indemnify the company for any losses sustained as a result of the breach.

Looking for extra marks?

If you are required to discuss the **s 173** duty, an analysis of the duty, together with a discussion of its common law predecessor, can be found in Andrew Keay, 'The Duty of Directors to Exercise Independent Judgment' (2008) 29 Co Law 290.

Duty to exercise reasonable care, skill, and diligence

The fourth general duty can be found in **s 174** and places a duty on directors to 'exercise reasonable care, skill and diligence'. The common law had imposed a similar duty on directors long before the **CA 2006** was passed (***Re City Equitable Fire Insurance Co Ltd* [1925]**), but the common law duty was heavily subjective and based on the skills and experience that the director actually had. Accordingly, a director with little skill or experience would be subject **(p. 75)** to an extremely low standard of care (see e.g. ***Re Cardiff Savings Bank* [1892]**; ***Re Brazilian Rubber Plantations and Estates Ltd* [1911]**).

The effect of the subjective duty was to allow unskilled, inexperienced, and incompetent directors to use their deficiencies as a shield against liability. Accordingly, the courts added an objective element to the duty and this dual subjective/objective test has now been incorporated into the **s 174** duty. **Section 174(2)** provides that the standard of care, skill, and diligence expected of a director is based on that of a reasonably diligent person with:

> **(a)** the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and
> **(b)** the general knowledge, skill and experience that the director actually has.

The test found in (a) imposes an objective minimum standard of care that will apply to all directors, irrespective of their individual capabilities. Accordingly, directors can no longer use their lack of skill or experience as a means of lowering the standard of care. However, this standard will take into account the functions of the director, so the

standard will likely vary from director to director (e.g. the standard imposed on a director of a small private company will likely differ to the standard imposed on a director of a listed company), thereby providing the courts with a measure of flexibility. The test found in (b) imposes a subjective standard that will apply where the director has some special skill, qualification, or ability (e.g. he is a lawyer or an accountant), and will serve to raise the standard expected of the director.

Looking for extra marks?

Be prepared to critically evaluate this dual test. Imposing higher subjective standards is a controversial issue. The rationale behind it is that such qualified persons are employed to bring their special skills or knowledge to bear (and are likely to be paid more as a result), so the imposition of a higher standard requires them to use such skills. The counter-argument is that the higher standard might deter such qualified persons from undertaking directorial office.

Section 174 establishes the test the courts must use, but does not provide any guidance as to how to apply the test, or what sort of factors will be relevant in determining whether or not a breach has occurred. Accordingly, pre-2006 case law will remain highly relevant (although much of it is first instance) with the following leading case providing an especially useful series of principles that have been widely cited by subsequent courts.

Re Barings plc (No 5) [2000] 1 BCLC 523 (CA)

FACTS:

Barings Bank collapsed in 1995 following the unauthorized trading activities of a trader named Nick Leeson, which resulted in the bank sustaining losses of £827 million. The case concerned three of the bank's directors who, it was alleged, had made serious errors of management in relation to Leeson's activities. At first instance, Jonathan-Parker J held that the three directors should be disqualified.

(p. 76) **HELD:**

The Court of Appeal upheld the disqualifications and, more importantly, it affirmed a series of principles laid down at first instance by Jonathan-Parker J in relation to the duty of skill and care, namely:

- Directors have a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties.
- Whilst directors are entitled to delegate particular functions to those below them, and to trust their competence and integrity to a reasonable degree, such delegation will not absolve the director of the duty to supervise the discharge of the delegated functions.
- The extent of the duty, and the question as to whether it has been discharged, must depend on the facts of each particular case, including the director's role in the company's management.

A director who causes his company to sustain a loss due to a failure to exercise reasonable care, skill, and diligence will be liable to compensate the company for such loss.

Duty to avoid conflicts of interest

Section 175 contains the first of several duties relating to conflicts of interest and provides that '[a] director of a company must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company'. **Section 175(2)** provides that this duty arises in particular to 'the

exploitation of any property, information or opportunity' and it is irrelevant whether or not the company wishes or is able to take advantage of the property, information, or opportunity. The fact that the profit made by the director is negligible is also irrelevant (***Towers v Premier Waste Management Ltd* [2011]**). **Section 175(3)** states that **s 175** does not apply to transactions between a director and the company (i.e. **s 175** only applies to transactions between a director and a third party). The duty is extremely strict as can be seen in the following case.

Bhullar v Bhullar [2003] EWCA Civ 424

FACTS:

For over 50 years, the families of two brothers (M and S) had run a company that let commercial property. Following an argument, it was decided that the families would part ways. The claimants (M's family) proposed that the company should not acquire any further properties and the defendants (S's family) agreed. A director, who was part of the defendants' family, discovered, by chance and not whilst acting in the course of the company's business, a piece of property near to a piece of property owned by the company. Through another company that they owned, the defendants acquired this property without informing the claimants. The claimants alleged that the defendants had acted in conflict with the interests of the company.

HELD:

Although the defendants acquired knowledge of the property in a 'private' capacity, the opportunity to purchase the property was one that belonged to the company. Whether or not the company could have or would have acquired the property (because it was in the process of being wound up) was irrelevant.

(p. 77)

Looking for extra marks?

This case has been heavily criticized, largely because the company agreed, at the claimants' behest, not to acquire any more properties. The Court, in effect, allowed the claimants to change their minds opportunistically at the moment an attractive commercial opportunity arose. For a detailed discussion of this case, see Hans C Hirt, 'The Law on Corporate Opportunities in the Court of Appeal: *Re Bhullar Bros Ltd*' [2005] JBL 669. See also the case of ***Regal (Hastings) Ltd v Gulliver* [1967]**.

Section 175 preserves the strict and inflexible position evidenced in ***Bhullar*** and there is little doubt that the case would be decided the same way under **s 175**. However, pre-**CA 2006** law did mitigate the harshness of the rule in one important respect, namely that the duty would not be breached if the director disclosed the nature of the conflict and obtained authorization.

Section 175(5) preserves this rule, but amends the requirement of authorization. Under pre-2006 law, the director could disclose the conflict and obtain authorization from the company in general meeting, but companies could provide, in their articles, that disclosure and authorization from the board would be sufficient. Under the **CA 2006**, where the company is private, authorization from the directors alone will suffice (unless the constitution provides otherwise (the model articles contain no such prohibition)) therefore avoiding the need to organize a general meeting. The directors of public companies can provide authorization, but only if the constitution so provides (the model articles do not contain a provision allowing the directors to authorize a conflict).

Where a director fails to obtain valid authorization, any resulting contract is voidable at the company's instance, provided that the third party involved had notice of the director's breach (***Hely-Hutchinson & Co Ltd v Brayhead Ltd* [1968]**). In addition, the company can require the director to account for any profit made as a result of the conflict (*Aberdeen Railway Co v Blaikie Bros* (1854)).

Revision tip

As noted, the general duties are not mutually exclusive and a single act may breach several duties. In ***Industrial Development Consultants Ltd v Cooley* [1972]**, the court held that a director who fails to disclose the existence of a conflict may, in addition to breaching a duty involving a conflict of interest, also breach the duty to act in the interests of the company—it is likely that this will continue to apply to the successor duty found in **s 172**.

Duty not to accept benefits from a third party

The sixth general duty can be found in **s 176** and provides that a director must not accept from a third party a benefit conferred by reason of his being a director, or by doing (or not doing) anything as a director. As with **s 175**, motive is irrelevant and it will be no defence for the director to argue that he acted in good faith. However, the **s 176** duty will not be breached where 'the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest' (**CA 2006, s 176(4)**). Accordingly, the duty only arises in relation to benefits that are likely to give rise to a conflict of interest.

(p. 78) Revision tip

Given that the **s 176** duty only arises in relation to benefits that are likely to cause a conflict, it might be thought that the **s 176** duty is irrelevant as **s 175** would cover such cases. Certainly, there is a significant overlap between **ss 175 and 176**, but there is a key difference. A conflict under **s 175** can be authorized by the directors, whereas a conflict under **s 176** can only be authorized by the members in general meeting (this is not expressly stated, but is a consequence **s 180(4)(a) of the CA 2006**, which preserves the common law rules relating to authorization). This clearly indicates that the receipt of benefits from third parties constitutes a greater danger to board impartiality than the conflicts covered solely by **s 175**.

Should a director accept an unauthorized third-party benefit, the company can rescind the contract and the benefit can be recovered (***Shipway v Broadwood* [1899]**). Instead of recovering the benefit, the company can claim damages in fraud from either the director in breach or the third party. In addition, the company can summarily dismiss the director (*Boston Deep Sea Fishing Co v Ansell* (1888)).

Duty to declare interest in proposed transactions or arrangements

The seventh and final general duty can be found in **s 177**, which provides that '[i]f a director of a company is in any way, directly or indirectly, interested in a proposed transaction or arrangement with the company, he must declare the nature and extent of that interest to the other directors'. The declaration must be made before the company enters into the transaction or arrangement (**CA 2006, s 177(4)**). Two points should be noted:

- Like **s 176**, the **s 177** duty only applies to transactions/arrangements that are likely to give rise to a conflict of interest.
- As the duty covers indirect transactions/arrangements, the director does not actually need to be a party to the transaction/arrangement in order for the **s 177** duty to be breached.

Revision tip

In problem questions involving a conflict of interest, students are often unsure whether to discuss **s 175** or the duty found in **s 177**. It is important that you understand the differences between the two duties as they are

generally mutually exclusive (i.e. a single act cannot give rise to a breach of both duties). The key difference is in the scope of the two duties. **Section 175(3)** states that **s 175** does not apply to transactions between a director and the company. Conversely, **s 177** does apply to transactions between the director and the company. Understanding the different scope of the duties will better enable you to identify which duty should be discussed.

The **s 177** duty relates to *proposed* transactions or arrangements only. *Existing* transactions or arrangements are covered by **s 182**, which provides that where a director is interested in an existing transaction or arrangement that has been entered into by the company, he must declare the nature and extent of that interest to the directors. The duty found in **s 182** is **(p. 79)** likely to be supplementary to the duty found in **s 177**, as opposed to being a general duty in its own right.

Where a director enters into a transaction in contravention of **s 177**, the transaction is voidable at the company's instance. Where a director enters into a transaction in contravention of **s 182**, he commits an either way offence (**CA 2006, s 183**).

Looking for extra marks?

A breach of **s 182** results in criminal liability being imposed, but no criminal sanctions will be imposed for a breach of **s 177** (indeed, no liability, civil or otherwise, will be imposed upon the directors). **Section 317(7) of the Companies Act 1985** (now repealed) imposed criminal liability on directors who failed to disclose an interest in proposed or existing contracts. It has been argued that there is no justification for differentiating between **s 177** and **s 182** in this way, because if **s 177** is breached and the proposed transaction/arrangement is adopted, then **s 182** will also be breached if the director then fails to declare the interest as soon as is reasonably practicable.

A failure to comply with **s 182** will not invalidate the transaction/arrangement, nor can the director involved be made to account for any gains made or indemnify the company for losses sustained (***Coleman Taymar Ltd v Oakes* [2001]**), although such remedies may be obtained if a breach of any other general duties has occurred.

Revision tip

Sections 175, 176, 177, and 182 all relate to conflicts of interest. A single or continuing act or omission can often result in breaches of multiple duties. For example, a director may fail to disclose an interest in a proposed transaction, thereby causing a breach of the duty contained in **s 177**. Once the company enters into the transaction, if the director does not disclose the interest as soon as is reasonably practicable, he will also breach the duty found in **s 182**. The non-disclosure and his failure to disclose his own breach of duty may also amount to a breach of **s 172**. Ensure that you are aware of the differences between the various provisions, and the ways in which they can overlap. Table 5.1 demonstrates the differences between the various conflict of interest duties in relation to disclosure and authorization.

Table 5.1 Disclosure and authorization of conflicts of interest

Duty	Disclosure required?	When is disclosure required?	Is authorization required?
Section 175—Duty to avoid conflicts of interest	The **CA 2006** does not expressly require the director to disclose the conflict/benefit. However, as authorization is required, the director will, in practice, need to disclose the existence of the conflict/benefit prior to obtaining authorization. Further, the courts have made clear that a director should disclose the existence of a conflict/benefit in order to comply with the duty to act in the interests of the company (***Industrial Development Consultants Ltd v Cooley* [1972]**) and it is likely that this will continue to apply in relation to the duty imposed by **s 172**		Yes. In private companies, the directors can authorize the interest, provided that the constitution does not prohibit such authorization. In public companies, the directors can authorize the interest only if the constitution so provides
Section 176—Duty not to accept benefits from third parties			Yes. The benefit must be authorized by the members in general meeting
Section 177—Duty to declare interest in proposed transactions or arrangements with the company	Yes. The director must disclose the nature and extent of the interest to the other directors	Disclosure must be made prior to the company entering into the transaction or arrangement	No, but if the directors do not approve of the transaction/arrangement, they will likely prevent the company from entering into it
Section 182—Duty to declare interest in existing transactions or arrangements entered into by the company	Yes. The director must disclose the nature and extent of the interest to the other directors	Disclosure must be made as soon as is reasonably practicable	No

Transactions requiring approval of the members

In addition to the general duties, the law imposes more specific 'duties' in relation to certain transactions or arrangements the directors enter into with the company (as these transactions are between the company and the director, they could be regarded as specific cases involving a conflict of interest). In relation to such transactions or

arrangements, compliance with the general duties is insufficient (**CA 2006, s 180(3)**) and member approval is also required.

> Revision tip
>
> Exam questions featuring one or more of the four specific statutory duties are reasonably common (often alongside problem questions relating to the general duties), so ensure that you are aware of these specific duties and the requirement of member approval.

(p. 80) Service contracts

Historically, directors would try and make it prohibitively expensive to remove them from office by negotiating lengthy service contracts. For example, if a company wished to remove a director five years before his service contract is to end, and he was paid £2 million per year, the company may need to pay the director £10 million in compensation for early termination of his contract.

This practice has now been curtailed by **s 188 of the CA 2006**, which provides that a director cannot have a guaranteed term of employment of over two years, unless it has been approved by a resolution of the members (**Principle D.1.5 of the UK Corporate Governance Code** recommends contracts or notice periods be no longer than one year). Where **s 188** is breached, the relevant contractual provision will be void and the contract will be deemed to contain a term allowing the company to terminate it at any time by giving reasonable notice (**CA 2006, s 189**).

(p. 81) Substantial property transactions

Under the general duties, a director with a conflict of interest can avoid committing a breach of duty if he discloses that interest to the other directors (although **ss 175 and 176** also require authorization). However, where the arrangement constitutes a 'substantial property transaction', disclosure alone is insufficient and the company must not enter into the arrangement unless it has first been approved by a resolution of the members, or is conditional upon such approval being obtained (**CA 2006, s 190(1)**). Two types of arrangement require such approval:

1. where a director of a company, or a person connected with the director, acquires, or is to acquire, a substantial non-cash asset; or
2. where the company acquires, or is to acquire, a substantial non-cash asset from such a director or person so connected.

A 'non-cash asset' is 'any property or interest in property, other than cash' (**CA 2006, 1163(1)**) and it will be substantial if it is (i) over £100,000, or (ii) exceeds 10 per cent of the company's asset value and is more than £5,000 (**CA 2006, s 191(2)**).

A substantial property transaction entered into without member approval is voidable at the company's instance, unless (i) restitution is impossible; (ii) the company has been indemnified, or; (iii) a third party's rights would be affected (**CA 2006, s 195(2)**). Additionally, any director or connected person involved in the arrangement will be liable to account for any gains made, and will be liable to indemnify the company for any losses sustained as a result of the arrangement.

Loans, quasi-loans, and credit transactions

Under the **CA 1985**, companies were generally prohibited from making any form of loan to its directors, and breach of this prohibition constituted a criminal offence. The **CA 2006** takes a very different approach that is dependent upon the type of transaction in question:

- No company can make a loan to a director unless the transaction has been approved by a resolution of the

members (**CA 2006, s 197(1)**).

- A public company cannot make a quasi-loan to a director unless the transaction has been approved by a resolution of the members (**CA 2006, s 198(2)**). A quasi-loan occurs where a company agrees to pay a sum on behalf of the director, or where it reimburses expenses incurred by another due to the actions of the director.
- A public company cannot enter into a credit transaction (e.g. hire purchase or conditional sale agreements, the leasing or hiring of goods) with a director unless it has been approved by a resolution of the members (**CA 2006, s 201(2)**).

It should be noted that the requirement for member approval will not apply in certain cases (e.g. loans or quasi-loans that do not exceed £10,000 do not require approval). Where approval is needed, a failure to obtain such approval will result in the same remedies as failure to obtain approval for a substantial property transaction.

(p. 82) Payments for loss of office

The law requires that the members approve certain voluntary payments made by the company to directors losing office, with such payments being defined by **s 215(1) of the CA 2006**. A company cannot make such a payment unless the payment has been approved by a resolution of the members (**CA 2006, s 217(1)**), although certain payments are excluded from this requirement (e.g. payments that do not exceed £200, or payments that discharge an existing legal obligation).

Where approval is not obtained, the recipient will hold the payment on trust for the company, and any director who authorized the payment is jointly and severally liable to indemnify the company for any loss resulting from the payment (**CA 2006, s 222(1)**).

Relief from liability

A director who has committed a breach of duty may attempt, or be able, to obtain relief from liability in several ways:

- A director's service contract or the company's articles may contain a provision excluding liability for negligence, default, breach of duty, or breach of trust. Such provisions are void (**CA 2006, s 232(1)**). Similarly, provisions requiring the company to indemnify the director for losses sustained due to his breach of duty are also generally void (**CA 2006, s 233**).
- **Section 239 of the CA 2006** puts in place, for the first time, a statutory scheme concerning ratification of acts committed by directors that amount to negligence, default, breach of duty, or breach of trust (it will be noted that these are the grounds for a derivative claim, as discussed at p 139, 'The derivative claim'. Accordingly, ratification can serve to prevent a derivative claim from being brought (indeed, **s 263(2)(c)** provides that permission to continue a derivative claim will be refused where the act has been ratified)). Ratification requires a resolution to be passed. Where ratification occurs, any cause of action is extinguished, but acts that cannot be ratified under pre-2006 law (e.g. acts not *bona fide* in the interests of the company) cannot be ratified under **s 239**.
- Where an officer of the company is found liable for negligence, default, breach of duty, or breach of trust, then **s 1157 of the CA 2006** allows a court to grant that officer, either wholly or partly, relief from liability on such terms as it sees fit. An officer of the company can also petition the court for such relief.

Termination of office

A director's term of office may be terminated in numerous ways:

- The articles may provide that a director's office will terminate upon the occurrence of a specified event. For example, the model articles provide that a person will instantly and automatically cease to be a director if he is prohibited by law from being a director (e.g. because he has been disqualified).
- (p. 83) The director can relinquish office at any time by giving notice to the company and the company must accept his resignation.
- The company's articles may provide for the retirement of the directors by rotation. In practice, it is only public

companies that tend to require retirement by rotation (as discussed at p 64, 'Appointment').

Two forms of termination of office are more complex and deserve further discussion, namely removal and disqualification.

Removal

Section 168(1) of the CA 2006 provides that '[a] company may by ordinary resolution at a meeting remove a director before the expiration of his period of office, notwithstanding anything in any agreement between it and him'. Despite the wording, **s 168** can be used to remove multiple directors. It should also be noted that the words 'at a meeting' indicate that the written resolution procedure cannot be used.

The power granted to members by **s 168** appears extremely substantial, but two factors mitigate its usefulness. First, a removal under **s 168** does not deprive the director of compensation payable as a result of the removal (**CA 2006, s 168(5)**). If the director's remuneration is substantial, or his service contract lengthy, this compensation may be extremely high. Second, **s 168** does not prohibit companies from including weighted voting clauses in their articles (the model articles do not provide for weighted voting rights). Such a clause usually provides that, in the event of a vote seeking to remove a director from office, the voting power of the director will be increased, usually to such an extent as to enable him to defeat any resolution seeking his removal. The case of ***Bushell v Faith*** **[1970]** provides an excellent example of how weighted voting clauses can weaken the power granted to shareholders by **s 168**.

> Looking for extra marks?
>
> In practice, the effect of weighted voting clauses may be more limited than many realize. First, the clause in ***Bushell*** was justified on the ground that the company in question was a quasi-partnership, and it may be the case that such clauses are effective only in relation to such companies (although no *rationes* or *dicta* exist to this effect). Second, such clauses will breach the **Listing Rules**, and so will not be adopted by listed companies. Third, a weighted voting clause could be removed by passing a special resolution.

It should be noted that a removal can take place other than under **s 168**. **Section 168(5)(b)** provides that **s 168** should not be construed as derogating from any power to remove a director that exists outside **s 168**. Accordingly, the power to remove a director under **s 168** exists alongside any other power (e.g. the articles may contain a provision allowing the directors to remove a board member via a board resolution). The advantage of using a separate board power is that it will not be subject to the procedural requirements found in **s 168**.

(p. 84) Disqualification

The members may be able to remove a director from office but the **Company Directors Disqualification Act 1986 (CDDA 1986)** grants the court the power to make an order disqualifying a person from promoting, forming, or taking part in the management of a company (or LLP) without the leave of the court. Numerous grounds for disqualification exist, including:

- A person can be disqualified if he commits an indictable offence in connection with the promotion, formation, or management of a company (**CDDA 1986, s 2**).
- A person can be disqualified if he is a director of a company that has become insolvent, and his conduct as a director makes him unfit to be concerned in the management of the company (**CDDA 1986, s 6**). Most disqualifications occur under **s 6**.
- A director can be disqualified where he has been found to have engaged in fraudulent trading or wrongful trading (**CDDA 1986, s 10**).

Revision tip

In problem questions, you may be required to advise a director of the possible consequences of his actions. Students tend to ignore the potential for disqualification, and focus solely on the rescission of transactions, the payment of compensation or the imposition of criminal liability. A director who could be barred from acting as a director for numerous years will clearly want to know of this potential consequence, so make sure you are aware of the grounds for disqualification.

Breach of a disqualification order constitutes an either way offence. Further, a person who acts as a director whilst disqualified can be personally liable for the debts and liabilities of the company incurred during the duration of the contravention (**CDDA 1986, s 15**).

Key cases

Case	Facts	Principle
***Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame* [1906]** 2 Ch 34 (CA)	The directors refused to exercise a power of sale granted to them by the articles. The members tried to exercise the power themselves by passing an ordinary resolution.	The division of power between the directors and the members is a matter for the articles, and where the articles grant a power to the directors only, then only the directors may exercise that power.
***Bushell v Faith* [1970]** AC 1099 (HL)	A company's articles provided that, in relation to resolutions to remove a director, the voting power of the director involved would be trebled.	The **Companies Act 1948** did not prohibit weighted voting clauses and so the clause in this case was effective.
***Howard Smith Ltd v Ampol Petroleum Ltd* [1974]** AC 821 (PC)	A company issued a batch of shares to the defendant in order to relegate the claimant to the status of minority shareholder, and thereby prevent it from blocking the defendant's takeover bid.	The courts should determine the dominant purpose of the exercise of power. If proper, no breach will occur, even if subservient improper purposes exist, and vice versa.
***Mutual Life Insurance Co of New York v Rank Organisation Ltd* [1985]** BCLC 11 (Ch)	An issue of shares on preferential terms was denied to members in certain locations, due to the cost of complying with the laws of those locations.	Where the interests of the company and some part of its members conflict, preference should be given to the interests of the company.
***Re Barings plc (No 5)* [2000]** 1 BCLC 523 (CA)	Several directors were disqualified due to their failure to monitor an employee who engaged in financial transactions that caused the company's collapse.	The duty to exercise skill and care require directors to acquire sufficient knowledge of the company's business, and monitor those to whom managerial functions have been delegated. The duty will be affected by the directors' role and function.
***Salmon v Quin & Axtens Ltd* [1909]** AC 442 (HL)	The company's articles provided that the company's ability to acquire certain properties was subject to the veto of two named members.	The director's general power of management is subject to the articles and, where the articles limit the director's powers of management, the limitation will be upheld by the courts.

(p. 85) Key debates

Topic	**Duty to promote the success of the company for the benefit of its members.**
Author/Academic	Deryn Fisher
Viewpoint	Argues that the duty found in **s 172 of the CA 2006** will not make directors consider the interests of non-shareholder constituents, and contends that the pluralist approach might provide a more inclusive approach.
Source	'The Enlightened Shareholder: Leaving Stakeholders in the Dark—Will Section 172(1) of the Companies Act 2006 Make Directors Consider the Impact of Their Decisions on Third Parties?' (2009) 20 ICCLR 10.
Topic	**Conflicts of interest**
Author/Academic	Bryan Clark
Viewpoint	Discusses the common law relating to directors who have interests that conflict with those of their companies and argues that the retention by the **CA 2006** of a strict approach is correct.
Source	'UK Company Law Reform and the Directors' Exploitation of Corporate Opportunities' (2006) 17 ICCLR 231.

 Exam questions

Essay question

'The codification of directors' duties has done little in practice to improve the law.'

Do you agree with this statement? Provide reasons for your answers.

See the Outline answers section in the end matter for help with this question.

Problem question

Ethos plc is a major, international graphic design company. One of Ethos's directors, Mike, is in extreme financial difficulty and is close to having to declare himself bankrupt (which would make him ineligible to act as a director of Ethos). Accordingly, to prevent this, the other directors of Ethos cause the company to lend Mike £15,000. The transaction is disclosed at a meeting of the directors and the directors unanimously agree to authorize the loan. Mike was present at this meeting, but did not vote on whether the loan should be made.

Ethos' articles of association state that 'Ethos plc may engage in any activity directly related, or incidental to, the carrying on of a graphic design business'. The directors of Ethos cause the company to lend £5,000 to Ceri, who will then pay off the loan over a two-year period. Ceri is a major client of Ethos but, aside from this, she has no other links with the company or its directors. A number of Ethos members hear of the loan and argue that Ceri must repay the money immediately.

The board of Ethos discover that Asset Strip plc is considering a takeover bid of Ethos. Asset Strip plans to break up the various parts of Ethos and sell them off individually and to remove the company's directors. Ethos is making a considerable profit and the directors genuinely believe that it would not be in the interests of the company or its members for Ethos to be taken over by Asset Strip. Accordingly, the directors cause the company to issue new shares to Sylvia—an existing member who is known to oppose the takeover—with the aim of preventing the takeover from succeeding.

Discuss whether or not Ethos or any of its directors have breached the law.

Online Resource Centre

To see an outline answer to this question log on to www.oxfordtextbooks.co.uk/orc/concentrate/

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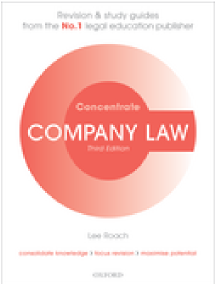

Company Law Concentrate: Law Revision and Study Guide (3rd edn)

Lee Roach

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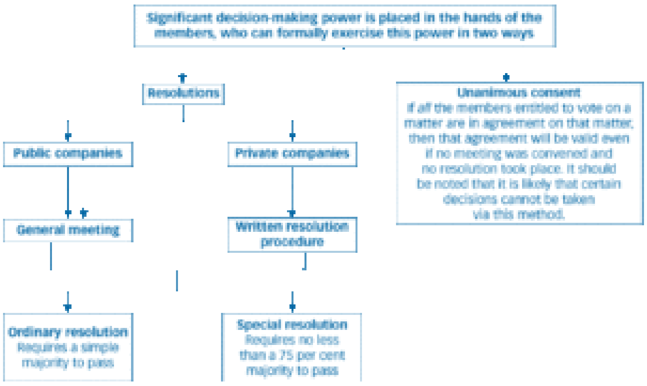
6. Members

Chapter: (p. 87) 6. Members
Author(s): Lee Roach
DOI: 10.1093/he/9780198703808.003.0271

Key facts

- Although the terms ‘member’ and ‘shareholder’ tend to be used interchangeably, there is a distinction (especially in companies that do not have a share capital).
- Members usually exercise their decision-making powers via the passing of resolutions. A resolution is simply a formal vote.
- The two forms of resolution are ordinary resolutions (which require a simple majority) and special resolutions (which require a majority of no less than 75 per cent).
- Public companies must pass resolutions at general meetings. Private companies must pass resolutions at general meetings, unless the written resolution procedure is used.
- Resolutions are only valid if sufficient notice of the meeting is provided and a quorum is present. A quorum is simply the minimum number of persons required to be present in order to conduct business.
- Members can appoint a proxy to attend, speak, and vote at general meetings on their behalf.
- The general belief amongst academics is that general meetings do not provide a satisfactory forum for shareholder democracy.

(p. 88) Chapter overview



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(p. 89) Introduction

The members of a company play two vital roles. First, through the purchase of shares, they contribute capital to the company. The nature of the share and share capital is discussed in chapter 8. This chapter will focus on the second vital role that the members play, namely their ability to make decisions. As will be seen, a significant amount of power is placed into the hands of members and numerous key decisions are reserved for them alone. However, before the members' ability to exercise this power can be discussed, it is important to note the difference between a 'member' and a 'shareholder'.

Members and shareholders

Many statutes and textbooks (including this text) tend to use the terms 'member' and 'shareholder' interchangeably and, in the vast majority of cases, a member will be a shareholder and vice versa. There is a difference, however, and it is important to understand the difference. The most obvious difference occurs in companies without a share capital—such companies will have members, but will not have shareholders.

Revision tip

Although it is generally acceptable to use the terms member and shareholder interchangeably, if you are referring to a company without a share capital, make sure that you use the term 'member'. As the term 'member' is generally wider than the term 'shareholder', you may prefer to use the term 'member' in general (indeed, the **CA 2006** uses the word 'member' significantly more than the word 'shareholder').

The distinction exists even in companies that do have a share capital. Purchasing shares will make a person a shareholder, but it will not automatically make him a member. **Section 112 of the CA 2006** provides that a person will only become a member of a company once he has agreed to become a member and his name has been entered on the register of members.

Resolutions

As is discussed in chapter 4, the general power to manage the company is usually vested in the directors by the

company's articles. Despite this, the **CA 2006** and the **Insolvency Act 1986 (IA 1986)** place considerable decision-making power in the hands of the members, including:

- the members can alter the company's articles (see p 55, 'Alteration of the articles')
- if a company wishes to convert from a public company to a private company, or vice versa, or if an unlimited company wishes to convert to a private limited company, then the approval of the members will be required
- (p. 90) the members can remove a director (or directors) from office (see p 82, 'Termination of office')
- numerous loans and other transactions involving directors require the approval of the members (see p 79, 'Transactions requiring approval of the members')
- the members can petition the court to have the company wound up (see p 153, 'The petition for winding up').

Revision tip

For a full list of the decisions that are reserved for the company's members under the **CA 2006** and the **IA 1986**, see Derek French, Stephen Mayson and Christopher Ryan, *Mayson, French & Ryan on Company Law* (30th edn, OUP 2013) 382–4.

The company's members usually exercise this decision-making power via the passing of resolutions. A resolution is simply a more formal word for a vote, whereby the members resolve themselves or the company to a particular course of action.

Types of resolution

The **CA 2006** provides for two different types of resolution, namely:

1. **Ordinary resolution**—an ordinary resolution of the members is one that is passed by a simple majority (**CA 2006, s 282(1)**), namely over 50 per cent—remembering that an exact 50 per cent split will mean that the resolution is lost.
2. **Special resolution**—a special resolution of the members is one passed by a majority of not less than 75 per cent (**CA 2006, s 283(1)**). Special resolutions tend to be reserved for more important decisions and constitutional changes.

Often, the **CA 2006** (and this text) will simply state that a resolution is required, without specifying which type. In such cases, the resolution required will be an ordinary resolution, although the company will be free to specify a higher majority (or unanimity) by inserting a provision in the articles to that effect (**CA 2006, s 281(3)**). Where statute specifies that an ordinary or special resolution is required, the articles cannot alter the majority required.

The resolutions of public companies must be passed at a meeting of the members (**CA 2006, s 281(2)**). The resolutions of private companies can be passed at a meeting, or can be passed via what is known as a written resolution (**CA 2006, s 281(1)**).

Written resolutions

As is discussed later, the convening of, and the passing of a formal resolution at a meeting involves compliance with a substantial body of rules and procedures that can prove (p. 91) burdensome and potentially costly, especially for smaller companies. Further, where the number of members is small, or where the directors are the members, convening a general meeting in order to pass a resolution seems like a rather redundant exercise. Accordingly, the **CA 2006** allows private companies to pass a written resolution in substitute for a resolution passed at a meeting (except where statute provides that a meeting must be convened (e.g. where the resolution seeks to remove an auditor or director from office)). Written resolutions require the same majorities, and have the same force, as resolutions passed at meetings (**CA 2006, s 288(5)**).

Looking for extra marks?

Written resolutions were permitted under the **CA 1985** but were cumbersome and difficult to pass as, irrespective of the majority required by the 1985 Act if the resolution were to be voted on at a meeting, a written resolution required unanimity to pass. The **CA 2006** has remedied this flaw and written resolutions now require the same majority as if made at a meeting. Accordingly, written resolutions now serve the purpose required of them, namely to make decision making in private companies more efficient.

Where a written resolution has been proposed, a copy of the proposed resolution will be sent to each member along with a statement informing the member how to signify agreement and when agreement must be made by. Photocopying the resolution and posting it to the members is clearly a much quicker and cheaper method of decision-making that convening a meeting. Once a member has signified agreement, it cannot be revoked.

Looking for extra marks?

The written resolution procedure is an example of the ‘think small first’ philosophy behind the **CA 2006**. The **CA 1985** was heavily criticised for catering to large companies, whilst failing to acknowledge the needs of smaller companies. If an essay requires you to discuss the extent to which the **CA 2006** caters for smaller companies, the usefulness of the written resolution procedure, and the way the 2006 Act has improved its usefulness, is something that should be discussed.

Meetings

Except where the written resolution procedure is used, the members will exercise their decision-making powers by passing resolutions at meetings, of which there are two types:

1. Meetings that all of the members are entitled to attend are known as ‘general meetings’. The majority of meetings, including the Annual General Meeting (AGM), will constitute general meetings. It used to be the case that any meeting that was not an AGM was known as an extraordinary general meeting, but this phrase should no longer be used.
(p. 92) 2. Meetings which only a certain class of the members are entitled to attend are known as ‘class meetings’. These meetings are reserved for determining the class rights of certain members with special rights (discussed at p 122, ‘Classes of shares’).

The resolutions of public companies must be passed at meetings; resolutions of private companies must be passed at meetings unless the written resolution procedure is used. Accordingly, it is possible for a private company to go its entire existence without having to call a meeting. Conversely, public companies must hold at least one general meeting every financial year that will constitute an AGM (**CA 2006, s 336(1)**).

Looking for extra marks?

Under the **CA 1985**, public and private companies were required to hold an AGM, although private companies could opt out of this requirement. That private companies are, by default, not required to hold general meetings (unless statute requires a meeting be held) is evidence of how the **CA 2006** is better drafted to meet the needs of smaller companies when compared to the 1985 Act. In an essay discussing whether the 2006 Act provides a more suitable regulatory regime for small businesses, this is an important point to mention.

Resolutions passed at general meetings are only valid if the procedural requirements established by the **CA 2006** are complied with (**CA 2006, s 301**) and these usually cannot be excluded by the articles.

Revision tip

The procedural requirements laid down by the **CA 2006** are extensive and burdensome, especially for smaller companies. This is why the written resolution procedure is so potentially valuable for smaller companies, and why private companies are not generally required to hold general meetings.

The calling of meetings

Generally, the power to call a general meeting is vested in the directors (**CA 2006, s 302**). **Section 303 of the CA 2006** does, however, allow the members to request that the directors call a general meeting, providing that the request comes from members representing at least 5 per cent of the company's paid-up share capital or, in the case of a company without a share capital, members representing at least 5 per cent of the voting rights of the members.

Looking for extra marks?

Do you think the 5 per cent threshold is a justified restriction on the members' power to request that a meeting be called? In larger companies, there is no doubt that the 5 per cent threshold will prove to be an insurmountable barrier for most private investors, so it is likely to be used only by institutional investors (discussed at p 104, 'Institutional investors').

(p. 93) If the directors fail to comply with a valid request from the members, then those members, or members representing over half the total voting rights of the company, are granted the power to call a meeting themselves, at the company's expense (**CA 2006, s 305**). Where it is impracticable to call a meeting in accordance with the above provisions, the court may order a meeting to be called (**CA 2006, s 306**).

Revision tip

Problem questions often feature decisions taken at a general meeting and the power to call a general meeting may also require a discussion of other areas of company law. For example, the directors are under a statutory duty to use their powers for a proper purpose (**CA 2006, s 171(b)**—discussed at p 69, 'Duty to act within the company's powers') and, if the directors call a meeting for an improper purpose (or improperly refuse the members' request for a meeting), a breach of duty may have occurred which can form the basis of a derivative claim (discussed at p 139, 'The derivative claim'). Similarly, if the majority shareholders call a meeting in order to adversely affect the minority, the majority's conduct may be regarded as unfairly prejudicial (discussed at p 148, 'Unfairly prejudicial conduct').

Notice of meetings

Resolutions passed at general meetings are only valid if adequate notice of the meeting is provided to persons entitled to such notice (**CA 2006, s 301**), namely:

- all of the company's members (**CA 2006, s 310(1)(a)**)
- all of the company's directors (**CA 2006, s 310(1)(b)**), and

- the company's auditor (**CA 2006, s 502(2)(a)**).

Notice must be provided within a sufficient period prior to the meeting. The general rule is that notice of a meeting must be provided at least 14 clear days prior to the meeting, rising to 21 clear days in the case of the AGM of a public company (**CA 2006, s 307(1) and (2)**). **Principle E.2.4 of the UK Corporate Governance Code** recommends that listed companies provide at least 20 working days' notice of an AGM. The company's articles are free to specify a longer notice period (**CA 2006, s 307(3)**), but cannot specify a shorter notice period (although the members themselves can agree to a shorter notice period).

Quorum

A general meeting, and any decisions made at it, will only be valid if a quorum is present. In relation to general meetings, a quorum is the minimum number of 'qualifying persons' required in order to validly conduct business. A qualifying person is:

- a member of the company
- a representative of a corporate member, or
- a proxy of the member (discussed later).

(p. 94) Where a limited company has only one member, that member will constitute a quorum (**CA 2006, s 318(1)**). In all other cases, two qualifying persons will constitute a quorum, unless the articles provide otherwise (**CA 2006, s 318(2)**).

If a quorum is not present, the meeting is said to be 'inquorate' and no business can be conducted at that meeting (although the model articles provide that an inquorate meeting can appoint a chairman for the meeting).

Voting

Regarding the passing of resolutions at a meeting, there are two methods of voting:

1. on a show of hands, or
2. by poll.

Where a decision is taken on a show of hands, each member will have one vote. Conversely, where a vote is taken by poll, unless the articles provide otherwise, each member will have one vote per share, except where the company has no share capital, in which case each member will have one vote (**CA 2006, s 284(3)**). The method of voting is a matter for the articles. The model articles provide that a resolution at a meeting will be decided on a show of hands, unless a poll is demanded in accordance with the articles. The members have the right to demand that a vote be taken on a poll, but the articles can stipulate that a certain number of members are required in order for such a demand to be valid (the model articles provide that two members are needed to demand a poll, and also that the chair of the meeting can demand a poll).

Proxies

Members need not attend a meeting in order to exercise their voting rights. **Section 324 of the CA 2006** grants members the right to appoint another person to exercise their right to attend, speak, and vote at general meetings, and this person is known as a 'proxy'. In large public companies, the appointment of proxies is especially important because only a small minority of the company's members will actually attend the meeting. Many other members will appoint a proxy to exercise their votes.

Looking for extra marks?

It is often argued that the ability to appoint a proxy emasculates the effectiveness of general meetings, especially in public companies. When such companies send out notice of a meeting, it is common for the

notice to contain a document allowing the member to appoint a proxy who can exercise the member's voting rights (although the member can instruct the proxy as to how to vote and the proxy must follow such instructions (**CA 2006, s 324A**)). Unsurprisingly, the person nominated by the company to act as proxy is usually one of the directors (normally the chairman), although the member is free to appoint whomever they choose. Accordingly, the directors will often be able to exercise the voting rights of many absent members, greatly increasing their voting power and making it difficult for members to defeat resolutions proposed by the directors.

(p. 95) The utility of meetings

As public companies are required to hold meetings and as, in such companies, the members can only exercise many of their key decision-making powers at meetings, the general meeting as a forum for shareholder democracy is of fundamental importance. In fact, general meetings are the only formal link between the company's members and the board, with **Principle E.2 of the UK Corporate Governance Code** providing that '[t]he board should use the AGM to communicate with investors and to encourage their participation'. Unfortunately, there is widespread dissatisfaction with the utility of general meetings as a forum for shareholder democracy for several reasons:

- In order for general meetings to provide a forum for shareholder democracy, they need to be well attended. In large public companies, however, meetings tend to be poorly attended.
- In order for general meetings to effectively hold the directors to account, the majority of shares should not be in the hands or control of the directors. In many private companies, the directors will be the members, so general meetings become largely redundant as the directors will own all, or the majority of, the company's shares. In public companies, many members will appoint one of the directors to act as their proxy, so the directors may have control of a significant proportion of the company's shares, thereby allowing them to defeat the resolutions of those who might wish to hold them to account.

Revision tip

The failings mentioned here have led many to argue that the general meeting serves no useful function and companies should not be required to hold them. The Company Law Review Steering Group recommended that public companies be able to opt out of the requirement to hold an AGM, but the government disagreed. Despite these failings, general meetings are still regarded as one of the most important corporate governance mechanisms. Be prepared to discuss the effectiveness of general meetings should an essay question require you to do so. Do you think general meetings should be abolished?

Unanimous consent

As noted, convening meetings can be a burdensome process. Even the written resolution procedure may appear unnecessary where all the members know they are in agreement on an issue. Accordingly, the common law has long provided that if all the members entitled to vote on a matter are in agreement on that matter, then that agreement will be valid even if no meeting was convened and no resolution took place (***Baroness Wenlock v The River Dee Co*** **(1883)**). This rule is known as the *Duomatic* principle, named after the case of ***Re Duomatic Ltd*** **[1969]**, where Buckley J stated:

> (p. 96) … where it can be shown that all the shareholders who have a right to attend and vote at a general meeting of the company assent to some matter which a general meeting of the company could carry into effect, that assent is as binding as a resolution in general meeting would be.

As this rule circumvents the rules and procedures relating to meetings and resolutions, it is unsurprising that strict

rules and safeguards are in place, including:

- Nothing less than unanimity will suffice—a member holding 99 per cent of the shares cannot, by himself, take advantage of the *Duomatic* principle (***Re D'Jan of London* [1993]**).
- The *Duomatic* principle cannot be used where the decision in question could not have been taken at a meeting (***Re New Cedos Engineering Co Ltd* [1994]**).
- It is likely that decisions that cannot be taken by written resolution (namely the removal of an auditor or director) are not subject to the *Duomatic* principle.

Revision tip

An agreement taken by unanimous consent is likely to be classified under **s 29 of the CA 2006** as an agreement that affects the company's constitution. Accordingly, such agreements may form part of the company's constitution and may be enforced by the company or its members (the company's constitution and its enforcement are discussed in chapter 4). It is also likely that such agreements will need to be registered with the Registrar of Companies.

Key debates

Topic	**Shareholder democracy and decision making**
Author/Academic	Richard C Nolan
Viewpoint	Examines the evolution of the law that governs shareholder decision-making and argues that the law can serve to unsatisfactorily restrict shareholder governance.
Source	'The Continuing Evolution of Shareholder Governance' [2006] CLJ 92
Topic	**The annual general meeting**
Author/Academic	The Company Law Review Steering Group
Viewpoint	Discusses the role and effectiveness of the AGM. Assesses a number of potential reforms, including abolishing the requirement for public companies to hold an AGM.
Source	*Modern Company Law for a Competitive Economy: Company General Meetings and Shareholder Communication* (DTI 1999)—available from www.bis.gov.uk/files/file23274.pdf

(p. 97) Exam questions

Essay question

In ***Re Dorman Long & Co Ltd* [1934]**, Maugham J stated that, in relation to general meetings, ‘the dice are loaded in favour of the views of the directors’.

Discuss the current validity of Maugham J’s statement. How effective are general meetings as a forum for shareholder democracy?

See the Outline answers section in the end matter for help with this question.

Problem question

Alyn and Helen run a successful partnership. In 2009, they incorporate their business (Coles & Wilkins Ltd) and 500 shares are issued. Alyn and Helen each take 100 shares, 200 shares are taken by Simon and the remaining 100 shares are taken by Diane.

The company’s accounts are audited by Hywel. It is apparent that Hywel has been negligently auditing the company’s accounts and Alyn, Helen, Simon and Diane all believe that Hywel should be removed before his period of office has expired. Alyn is aware of the consensus and so writes a letter to Hywel informing him that his office is terminated and he is no longer the company’s auditor.

Simon and Diane rarely attend meetings and Alyn shows little interest in attending board and general meetings. Helen therefore tends to run the business by herself, and the other members appoint her to act as their proxy. She uses this power to alter the articles and to change the company’s name to Wilkins Ltd.

Given that Alyn never attends board meetings, Simon and Diane are of the opinion that he should step down as a director but Alyn refuses. Simon and Diane request that the directors call a general meeting to decide the issue, but Alyn and Helen refuse. Accordingly, Simon and Diane convene a meeting themselves (at their own expense) and invite Alyn and Helen to attend. The meeting takes place and, as Simon and Diane collectively hold 300 shares compared to the directors’ 200 shares, they contend that the resolution is passed and Alyn should vacate office. Alyn points to a provision in the company’s articles, which states that a director can only be removed if a special resolution is passed. Simon and Diane state that Wilkins Ltd should reimburse them for the costs of the meeting.

Discuss whether any breaches of the law have occurred and whether the decisions taken have followed the applicable procedures.

Online Resource Centre

To see an outline answer to this question log onto www.oxfordtextbooks.co.uk/orc/concentrate/

Law Trove

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7. Corporate governance

Chapter: (p. 98) 7. Corporate governance
Author(s): Lee Roach
DOI: 10.1093/he/9780198703808.003.0295

Key facts

- The UK's system of corporate governance is largely voluntary, with the UK Corporate Governance Code providing the main corporate governance principles.
- Compliance with the UK Corporate Governance Code is recommended, but if a listed company does not comply with the Code, it must explain why it has not.
- When purchasing shares, insurance companies, pension funds, and banks etc. are known as institutional investors. Currently, over half of the shares in UK companies are in the hands of institutional investors.
- In order to prevent executive directors from determining their own pay, companies are encouraged to set up a remuneration committee consisting of non-executive directors.
- The Companies Act 2006 requires companies to disclose details concerning directors' remuneration and provides the members of quoted companies with the right to vote on certain remuneration issues.
- Although the Companies Act 2006 does not differentiate between executive and non-executive directors, the UK Corporate Governance Code places great emphasis on the corporate governance functions of independent non-executive directors.

(p. 99) Introduction

In recent years, largely due to corporate scandals such as Enron, Parmalat and BCCI, there has been an explosion of interest in corporate governance. Whilst the term 'corporate governance' might be of relatively recent origin, the topic itself has existed since the dawn of the registered company. It is only in the last two decades or so, however, that the topic has started to receive the attention that it deserves and, in that period, it has grown significantly in scope. In fact, the topic is too large to cover comprehensively in a single text, let alone a single chapter. Accordingly, this chapter will focus on a few key issues.

Revision tip

Corporate governance is now a major topic on many company law courses. Even if your course does not cover corporate governance as a distinct topic, corporate governance issues still have an impact upon many other areas of black-letter company law (as indicated by the frequent references to the **UK Corporate Governance Code** throughout this text). It is vital that you appreciate how our systems of company law and corporate governance interact with one another.

What is 'corporate governance'?

In recent years, the phrase 'corporate governance' has become one of the most ubiquitous phrases in the business world. Despite its importance and prevalence, however, there is no accepted definition as to what corporate governance actually is. The breadth of the topic is demonstrated by the definition of the Cadbury Committee, who defined corporate governance as 'the system by which companies are directed and controlled'. Whilst this definition is doubtless correct, it is also rather broad and vague. Given the massive expansion of the topic in recent years, it is likely that the phrase is not amenable to a short, pithy definition. Instead perhaps, it is preferable not to define what corporate governance is, but what it aims to achieve. The **UK Corporate Governance Code** provides a useful statement regarding the aims of corporate governance, stating that its purpose is 'to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company'.

Revision tip

For a useful discussion of what corporate governance is, see Jill Solomon, *Corporate Governance and Accountability* (4th edn, Wiley 2013) ch 1. For an account of the major corporate governance scandals that led to the increase in the prominence of corporate governance, see Christine A Mallin, *Corporate Governance* (4th edn, OUP 2012) ch 1.

Corporate governance reports and codes

UK company law has historically been based around a central Companies Act, with the **CA 2006** establishing the current legislative framework. Conversely, legislation is largely (p. 100) absent from the UK corporate governance system, with the vast majority of corporate governance principles deriving from a series of reports and codes. Within the last two decades, there have been a notable number of such reports and codes (often created as a result of some corporate scandal or emerging area of concern) and it is important that you understand how our self-regulatory system originated and has evolved. A discussion of all the codes and reports that have influenced our corporate governance system is beyond the scope of this text, but Figure **7.1** provides a timeline of the principal reports and codes.

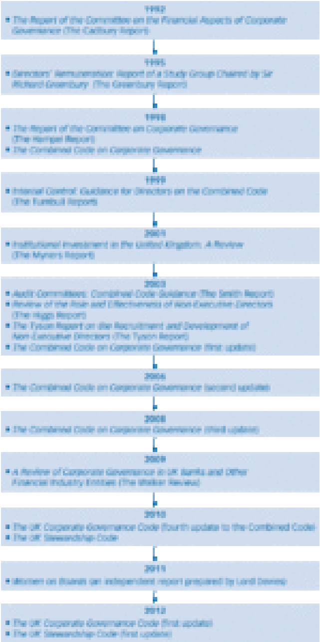

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Figure 7.1
Corporate governance reports and codes

> Revision tip
>
> An understanding of these codes will help you better understand the UK corporate governance system. The role and content of some of these codes, along with a number of international codes, is discussed in Christine A Mallin, *Corporate Governance* (4th edn, OUP 2012) ch 3.

The UK Corporate Governance Code

The main corporate governance principles are contained in the **UK Corporate Governance Code** (formerly known as the **Combined Code on Corporate Governance**). The Combined Code was first created in 1998 and served to merge the best practice recommendations contained in the Cadbury, Greenbury, and Hampel reports. As our corporate governance system has evolved and as subsequent reports have made new recommendations, the Code has been updated to reflect these changes. The Code was updated in 2003, 2006, 2008, and 2010, with the 2010 update changing the Code's name to the **UK Corporate Governance Code**. In 2012, the Code was again updated.

> Revision tip
>
> It is common for students to rely on older texts and journals that may focus on out-of-date versions of the Code, with many students referring to the Combined Code instead of its new title, the **UK Corporate Governance Code**. Make sure also to refer to the most recent version of the Code (the first update to the Code was published in October 2012 and is, at the time of writing, the most recent version of the Code). The website of the Financial Reporting Council (www.frc.org.uk) provides full details on the most recent version of the Code, including planned updates. At the time of writing, the Financial Reporting Council is considering amending the Code and, if it decides to do so, the updated Code will take effect from October 2014.

The Code establishes a number of principles in relation to a number of key areas of corporate governance. These

principles aim to ensure that the board of directors is effective and accountable, and that the powers of the chairman and CEO are not abused. The Code emphasizes the need for an open and effective dialogue between the board and its members.

(p. 101) (p. 102) Looking for extra marks?

In many cases, the principles contained in the Code go well beyond the requirements imposed by the **CA 2006**. Most students can effectively discuss the Act's provisions, but many students neglect the principles established by the Code, especially in problem questions. In issues of corporate governance, the Code is arguably more important than the **CA 2006**, so you should ensure that you are familiar with the Code's recommendations and their impact. For a discussion of developments relating to the impact and implementation of the Code, see FRC, *Developments in Corporate Governance 2013* (FRC 2013).

Although the principles contained in the Code are primarily aimed at larger companies, other companies are also encouraged to comply with the Code where appropriate. This is important to bear in mind, as many students incorrectly believe that the Code is of relevance to listed companies only (although it is true that the Code is of increased importance to listed companies). Companies are under no legal obligation to comply with the Code. However, the **Listing Rules** require that a listed company includes in its annual report:

- a statement indicating how the company has applied the main principles of the Code, and
- a statement indicating to what extent the provisions of the Code have been complied with and, if certain provisions have not been complied with, the company must provide its reasons for non-compliance (this has become known as the (p. 103) 'comply or explain' approach and is described by the **UK Corporate Governance Code** as 'the trademark of corporate governance in the UK').

Revision tip

Students often incorrectly state that companies, especially listed companies, must comply with the Code, but this is not the case. The principles contained within the Code are recommendations only, so a failure to comply with the Code's principles will not result in any legal sanction being imposed (although it may result in shareholder disapproval or damage to the company's reputation). However, if a listed company fails to include within its annual report the statements discussed here, then that will constitute a breach of the **Listing Rules**, which can result in the imposition of a penalty (**Financial Services and Markets Act 2000, s 91**).

The advantages and disadvantages of 'comply or explain'

It is generally accepted that the UK's corporate governance regime is effective and there is a high level of compliance with the Code amongst larger listed companies. A number of other countries have followed the UK's lead by creating corporate governance codes of their own and a recent EU Green Paper resulted in strong support being expressed for the 'comply or explain' approach. Several arguments have been advanced to explain the success of our governance regime:

- *Flexibility*—Corporate governance is a constantly evolving area and regulation needs to be able to adapt quickly to emerging practices and abuses. Updating legislation can be a lengthy process, whereas codes can be quickly altered without having to wait for a gap in the crowded parliamentary timetable and without having to pass through the legislative process (as is evidenced by the regular updates to the **Combined Code/UK Corporate Governance Code**, and the **UK Stewardship Code**).
- *Expertise*—Codes are usually drafted and updated by, or following consultation with, the industries or entities

that they are designed to apply to. In other words, they are drafted by, or with the aid of, experts in their relevant field and, as a result, the principles are more likely to be effective, and are more likely to be accepted by the industry.

- *Efficiency and cost*—As the various codes are drafted and updated by experts, the drafting and updating process is likely to be achieved on a more cost-efficient basis. Further, the cost of these codes is often borne by the industry in question, whereas the taxpayers bear the cost of statutory regulation.

However, comply or explain can suffer from some notable disadvantages, including:

- *Enforcement*—As these codes provide recommendations only that lack the force of law, they often lack effective sanctions. A breach of the Code brings no sanction in itself, but a failure to include the compliance statements can result in a breach of the **Listing Rules**, under which the Financial Conduct Authority can administer penalties.
- *Bias*—As these codes are drafted by, or drafted following consultation with, the industries or persons to whom the codes are intended to apply, there is always the danger that the codes will favour those industries/persons by advocating lax standards or ineffective recommendations.

> Revision tip
>
> Knowing the advantages and disadvantages of our governance system is vital if you should be required to answer an essay question on the effectiveness of the UK's corporate governance regime, or be required to compare self-regulation to regulation by the law. For an excellent (albeit ageing) analysis of self-regulation in relation to companies, see Brian Cheffins, *Company Law: Theory, Structure and Operation* (Clarendon 1997) ch 8.

Corporate governance mechanisms

A crucial role of the **UK Corporate Governance Code** is to encourage companies to establish mechanisms designed to promote good corporate governance and increase corporate accountability. Here, three prominent corporate governance mechanisms will be discussed, namely:

1. the role of institutional investors
2. the laws and principles relating to directors' remuneration, and
3. the role and effectiveness of non-executive directors.

Institutional investors

Often, we will transfer money to others so that they can look after it for us, or return it to us should certain events occur. We open bank accounts and trust banks to look after the money we place in those accounts. We pay money into pension funds so that, upon retirement, we will have a regular source of income. We pay insurance premiums to insurance companies so that, if certain unfortunate events occur, we will be compensated for the losses caused by those events.

When we transfer money to banks, pension funds, and insurance companies, they do not lock the money away until it can be returned to us. They use our money to make themselves a profit, with the purchasing of shares being a common method of obtaining (or trying to obtain) a profit. As they have access to significant funds, they can invest extremely heavily in the share market. The increasing share ownership of banks, pension funds, insurance companies, and unit trusts (or institutional investors as they have come to be known) has radically transformed the UK corporate governance landscape.

In 1963, 54 per cent of UK shares were in the hands of individual private investors, with 29 per cent of shares in the hands of institutional investors. Table 7.1 demonstrates how radically UK share ownership has changed since 1963.

Table 7.1 UK share ownership, 1963 and 2012

Identity of investor	% of shares held in 1963	% of shares held in 2012
Individuals	54	10.7
Insurance companies	10	6.2
Pension funds	6.4	4.7
Banks	1.3	1.9
Unit trusts	1.3	9.6
Overseas investors (largely overseas institutional investors)	7	53.2

 The trend is obvious. Ownership by individuals has decreased significantly, whilst institutional ownership (notably overseas institutional investment) has increased significantly. For the last few decades, the majority of shares in the UK have been in the hands of institutional investors. The question to ask is what significance does this have in relation to promoting good corporate governance. In order to answer this question, it is vital that you understand the relationship between the ownership and control of a company.

The separation of ownership and control

In 1932, two American academics named Adolf Berle and Gardiner Means published a book entitled *The Modern Corporation and Private Property*. The text argued that modern corporations had become so large and their members so numerous that the members had become unwilling, or unable, to exercise any meaningful form of control over the company's directors. The company's controllers (the directors) had become separated from its owners (the members) and could therefore escape owner control. The result was that the directors were able to engage in activity that benefited themselves, often at the expense of the company and/or the members. Clearly, for Berle and Means, the separation of ownership and control was a significant problem, but it has since become a defining characteristic of large companies in the UK and the USA.

Many academics argued that the growth of institutional investment could halt or even reverse the separation of ownership and control. Many of the corporate governance codes seen in Figure **7.1** have emphasized how important the governance role of institutional investors is and, with the publication of the **UK Stewardship Code** (discussed at p 107, 'The UK Stewardship Code'), there now exists a code devoted solely to encouraging institutional investor engagement. With over half the UK's shares in the hands of institutions, it might once again be possible for the members to intervene in corporate governance affairs and actively participate in the governance of companies. The owners could once again exercise a measure of control, with many American academics predicting that a new era of corporate accountability was on the horizon. This new era of accountability has yet to arrive, however, and institutional investors have generally not been able to live up to the bold promises made on their behalf.

Looking for extra marks?

Shareholder engagement has recently been a prominent topic in the media, largely due to shareholders rejecting the remuneration policy of certain companies (the shareholder vote in relation to directors' pay is discussed at p 108, 'Directors' remuneration'). This so-called 'shareholder spring' demonstrates that institutional investors can have significant impacts upon the companies in which they hold shares. The question that we now need to ask

is why are these impacts not occurring more often and across a greater range of issues.

The effectiveness of institutional investors

Before we discuss why institutional investors have not been as effective as many hoped, it is worth noting that the level of institutional investor activism may be higher than is apparent (p. 106) because institutional investors tend to engage in 'behind-the-scenes' negotiation. The reason for this is that, if a large institutional investor were to publicly display dissatisfaction with the way that a company is run, other members could panic which could trigger a 'race to exit'. Certainly experience has demonstrated that, in many cases, if a dispute between the company and its institutional investor becomes public, then everyone ultimately loses as the company's share price usually slumps. However, even taking into account the institutions' reputation for behind-the-scenes activism, there is still a widespread belief that institutional investors have not yet had the impact that many believed they would. The question is why.

Although over half of UK shares are in the hands of institutional investors, a single institutional investor will, in order to diversify their risk, typically not hold more than 5 per cent of shares in a single company. Accordingly, a single institutional investor will normally need to try and form a coalition with other investors. However, forming and maintaining a coalition of institutional investors can be a difficult task for several reasons:

- Shareholder activism involves expense in terms of time, effort, and cost. As the benefits of shareholder activism usually go to all the members (not just the active ones), it follows that passive members have no real incentive to expend resources in aiding the active members. This is known as the 'free rider' problem as the passive members can free-ride off the active members' efforts. This reduces the members' incentive to voluntarily co-operate, thereby making it harder to form a coalition of the necessary size.
- Institutional investors can only carry out their functions effectively if they have adequate information on the companies in which they hold shares. Acquiring such information can be costly. For smaller members, the costs of acquiring such information will usually outweigh the benefits. Larger members, such as institutional investors, may be able to bear the cost of acquiring information, but they will also need to disseminate that information to the other members. The combined costs of acquiring and disseminating the information may outweigh the benefits that would be gained should their efforts succeed.

However, despite the fact that institutional investors' activism has not resulted in a new era of accountability and shareholder control, they have still undoubtedly had an impact upon the UK's corporate governance system. In recent years, it has become clear that institutional investors have started to take their governance role more seriously, especially in relation to using the voting power of their shares. The **guidance to Principle 6 of the UK Stewardship Code** states that '[i]nstitutional investors should seek to vote all shares held' and the **guidance to Principle 3** states that they should 'attend the General Meetings of companies in which they have a major holding, where appropriate and practicable'. Today, most large institutional investors have a policy of attending AGMs and attempting to vote on all issues discussed at the AGM. However, voting levels, whilst steadily increasing, could be higher. The Myners Report stated that voting levels in 1999 stood at 50 per cent, compared (p. 107) to just 20 per cent in 1990. More recent research has institutional voting levels at around 60–65 per cent.

As stated earlier, UK institutional investors have a reputation for behind-the-scenes activism. However, in recent years, it would appear that the institutions have become more bold and, in certain governance areas (especially directors' remuneration), the institutions have been willing to engage in public and often bitter disputes with management and they have demonstrated that, when motivated, they can indeed improve standards of corporate governance.

Looking for extra marks?

For several examples of high-profile disputes between institutional investors and management, see Lee Roach, 'CEOs, Chairmen and Fat Cats: The Institutions are Watching You' (2006) 26 Co Law 297. See also the recent

spate of remuneration policy rejections mentioned at p 109, 'Disclosure'. For an accessible discussion of the role and effectiveness of institutional investors, see Christine A Mallin, *Corporate Governance* (4th edn, OUP 2012) ch 6, and Jill Solomon, *Corporate Governance and Accountability* (4th edn, Wiley 2013) ch 5.

However, there is still much scope for improvement. There are many who have argued that the recent financial crisis was caused, in part, by the failure of institutional investors to effectively monitor banks in which they held shares. The 2009 Walker Review backed this up to an extent by stating that institutional investors were 'slow to act' when concerns arose. The general view regarding institutional investors is that the effectiveness of their governance role has improved, but should improve further.

The UK Stewardship Code

In order to encourage greater institutional investor engagement, in July 2010, the FRC published the **UK Stewardship Code**, which, according to Baroness Hogg, the FRC's Chairman, will hopefully 'be a catalyst for better engagement between shareholders and companies and create a stronger link between governance and the investment process'. The Code establishes seven broad principles, namely that institutional investors should:

1. publicly disclose their policy on how they will discharge their stewardship responsibilities
2. have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed
3. monitor their investee companies
4. establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value
5. be willing to act collectively with other investors where appropriate
6. have a clear policy on voting and disclosure of voting activity and
7. report periodically on their stewardship and voting activities.

(p. 108) Like the **UK Corporate Governance Code**, certain persons (notably FCA-authorized fund managers) must comply with the Code or explain their reasons for non-compliance.

Looking for extra marks?

The **UK Stewardship Code** is the first of its kind in the world (although other countries are already following the UK's lead and creating Stewardship Codes of their own). As such, it is an extremely important development and you should be prepared to discuss how effective the Code is in promoting greater investor engagement. The consensus among academics and commentators is that the Code will have, at best, a modest effect upon engagement. For a discussion of the origins, scope, and effectiveness of the Code, see Brian Cheffins, 'The Stewardship Code's Achilles' Heel' (2010) 73 MLR 1004, and Lee Roach, 'The UK Stewardship Code' (2011) 11 JCLS 463. You should ensure that you refer to the most recent version of the Code (which, at the time of writing, is the October 2012 version).

Directors' remuneration

Generally, a director is an office holder and not an employee (although a director with a service contract will also be an employee). A consequence of this is that directors are not generally entitled to be remunerated for acting as director (***Hutton v West Cork Railway Co* (1883)**). However, this rule is usually excluded either by providing for the payment of remuneration in the director's service contract, or by including a provision in the company's articles providing the directors with the right to be remunerated for their services. Not only do the model articles provide the directors with a right to be remunerated, but they also provide that the directors themselves should determine the amount of remuneration they are to be paid. In the 1990s, concern over the levels of remuneration that directors were awarding themselves led to directors' remuneration becoming a controversial corporate governance issue. Recently,

the remuneration awarded to the executive directors of banks and prominent CEOs has once again placed the remuneration debate firmly in the public eye.

It is now universally acknowledged that directors' remuneration, and the mechanisms that determine it, are two of the most important factors that shape and direct the board's behaviour. To date, perhaps the most important mechanism is the remuneration committee.

Remuneration committees

As noted, the model articles allow the directors to determine their own pay, meaning that their level of remuneration is, as a matter of law, largely dependent upon their own self-discipline. Concern that directors would award themselves excessive remuneration packages led the Cadbury Committee to conclude that the determination of remuneration should be taken from the executive directors and given to another body, namely a remuneration committee. **(p. 109)** **Principle D.2 of the UK Corporate Governance Code** states that:

> There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.

Principles D.2.1 and D.2.2 of the UK Corporate Governance Code then go on to state that the board should establish a remuneration committee consisting of at least three (or two in the case of smaller companies) independent NEDs who are tasked with determining the remuneration of the executive directors. The remuneration of the NEDs is determined by the executives. Accordingly, theoretically, no director will be involved in determining his own remuneration.

Looking for extra marks?

Despite the fact that virtually all larger companies have established a remuneration committee, there is widespread dissatisfaction amongst academics with the effectiveness of remuneration committees for several reasons:

- Research suggests that companies with a remuneration committee actually pay their directors more than companies without such a committee.
- To ensure independence, the committee should consist entirely of non-executive directors (NEDs), but, as is discussed at p 112, 'Independence', the independence of many NEDs has been doubted.
- It is common for the committee to engage compensation consultants to help determine the levels of remuneration. These consultants may work for the remuneration committee, but are usually hired and/or paid by the executives.
- Many of the excessive remuneration packages that have caused public criticism in recent years were determined by a remuneration committee.

For an accessible discussion on remuneration committee best practice, see PWC, *Remuneration Committees: Good Practices for Meeting Market Expectations* (PWC 2006).

Disclosure

Although, the UK system of corporate governance is largely voluntary, directors' remuneration is one area where legal regulation does exist, especially in relation to the disclosure of directors' remuneration. The lack of compliance with the recommendations of the Greenbury Report led to the passing of the **Directors' Remuneration Report Regulations 2002**, the provisions of which can now be found in **Pt 15 of the CA 2006** and accompanying subordinate legislation. These provisions require companies to disclose in their annual accounts significant amounts

of information relating to directors' remuneration. Additionally, the directors of quoted companies must prepare a directors' remuneration report which must contain extensive details regarding the directors' remuneration (**CA 2006, s 420**). Every member is entitled to a copy of the report.

> ### Looking for extra marks?
>
> The aim behind these provisions is to inform the company's members and other interested parties and there is no doubt that the disclosure requirements are extensive. However, whilst the legislation states what the directors must disclose, it did not, until recently, state how the information should be disclosed, leading to companies disclosing masses of technical information that only served to (p. 110) confuse members. Fortunately, **Sch 8 of the Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008** was amended in 2013 to require quoted companies to provide in the remuneration report a standardized table that sets out a single total figure of remuneration for each director. This should allow for better comparison of remuneration between directors and across companies.

Granting the members access to details concerning the directors' remuneration would be of little value if they could not then use that information to hold the directors to account. Accordingly, **s 439 of the CA 2006** provides the company's members with the opportunity to approve the remuneration report. It should be noted that a failure to obtain member approval will not invalidate the report—the members' role under **s 439** in relation to the non-policy part of the report is advisory only (as is discussed later, the members' vote is binding in relation to the policy section of the report).

> ### Looking for extra marks?
>
> Allowing the members to vote on the remuneration report is a controversial issue and, in an essay involving the regulation of directors' remuneration, the issue is one you will likely need to discuss. For a discussion of the problems surrounding the involvement of members in remuneration issues, see Lee Roach, 'The Directors' Remuneration Report Regulations 2002 and the Disclosure of Executive Pay' (2004) 25 Co Law 141, 144–6.

Even though the members' role in relation to the non-policy part of the report is advisory only, a rejection of a company's remuneration report will be extremely humiliating and, in many cases, the company will take corrective action.

> ### Revision tip
>
> Back up your discussion with practical examples. An excellent example that demonstrates the consequences of the members refusing to approve the remuneration report (the first time such a rejection had occurred) occurred in 2003 when the remuneration report of GlaxoSmithKline plc was rejected by its members. Following the defeat, GlaxoSmithKline reduced drastically the golden parachute of its CEO, as well as halving the length of his service contract, and removed two key members from its remuneration committee. The recent so-called 'shareholder spring' also provided numerous examples of shareholders demonstrating dissatisfaction with, or outright rejection of, the remuneration reports of their companies (e.g. Aviva, Barclays, Cairn Energy, Centamin, Prudential, RBS, Regus, WPP), often leading to executive directors foregoing their bonuses (with the principal example being the then Chairman of Barclays, Bob Diamond, who in July 2012 gave up a £20 million bonus).

In March 2012, the Coalition Government published a consultation document in which it proposed the granting of a

binding vote to members on pay issues. This was implemented by the **Enterprise and Regulatory Reform Act 2013**, which inserted several new provisions (p. 111) into the **CA 2006**, the most important of which is **s 439A** which provides that the members will have the opportunity to approve, via an ordinary resolution, the policy section of the remuneration report at least every three years. This approval, unlike the approval for the non-policy section of the report, is binding and the company must act if the members reject the company's remuneration policy.

> Revision tip
>
> The remuneration provisions introduced by the **Enterprise and Regulatory Reform Act 2013** are significantly watered down versions of the provisions recommended in the consultation document and draft Bill. For example, the consultation document proposed that the binding vote on remuneration policy would take place every year. Do you think the provisions in the 2013 Act strike the right balance or do you think they have been unacceptably diluted?

Non-executive directors

At p 64, 'Appointment', it was noted that the appointment of directors should be led by a nomination committee consisting of NEDs. Earlier in this chapter, it was noted that the remuneration of the executives should be determined by a remuneration committee consisting of NEDs. The appointment of a company's auditor should also be led by an audit committee consisting of NEDs (**UK Corporate Governance Code, Principle C.3.1**). Accordingly, the **UK Corporate Governance Code** envisages a significant role for NEDs in promoting good corporate governance and, in recent years, their importance has increased significantly with the Higgs Report describing them as 'custodians of the governance process'.

What is a NED?

The **CA 2006** does not define what a NED is—in fact, it never uses the phrase 'non-executive director' and does not distinguish between executive directors and NEDs (see **CA 2006, s 250**). There is no doubt, however, that the NEDs do differ substantially from their executive counterparts in several ways:

- Executive directors typically work full-time, whereas NEDs only work part-time, devoting around one or two days a month to the company.
- As NEDs work part-time, they are paid considerably less than their executive counterparts. The Higgs Report found that NEDs in FTSE 100 companies were paid on average £44,000 per year and in smaller listed companies, they were paid £23,000 per year.
- Executive directors usually have a contract of service, thereby making them employees of the company. Conversely, NEDs are usually appointed under a letter of appointment and so are not usually employees.
- Whereas the executives' key role is the management of the company, the principal function of the NEDs is to monitor the activities of the company's executives from an (p. 112) independent standpoint. However, **Principle A.4 of the UK Corporate Governance Code** makes clear that NEDs are also expected to be involved in the company's management and to help develop the company's strategy.

> Looking for extra marks?
>
> The role of NEDs envisaged by the **UK Corporate Governance Code** has been criticized. It has been argued that the NEDs' two roles (i.e. management and monitoring of management) do not sit easily with one another and that the monitoring function of NEDs will have the effect of segregating them from the executives, thereby creating a split board. Some have argued that this will impose an implicit two-tier board philosophy upon a unitary board structure.

Independence

NEDs cannot effectively monitor management, nor can they bring a neutral viewpoint to developing policy if they are not independent of the executives. **Principle B.1.1 of the UK Corporate Governance Code** states that the annual report should identify which directors are considered to be independent—the Code also provides a list of relationships or circumstances that could affect a director's independence (e.g. the director is a significant shareholder or former employee of the company). The aim of these provisions is to ensure that the NEDs are genuinely independent, and not merely independent in name.

> ### Looking for extra marks?
>
> Practical examples should be used to back up the arguments you make. The danger of branding NEDs as independent when they are not is starkly demonstrated by the collapse of Enron. Of Enron's 15 directors, 13 were identified by the company as independent. An investigation carried out by the US Senate revealed that many of Enron's independent directors in fact had financial ties with the company that cast serious doubts upon their impartiality. The US Senate concluded that this lack of independence resulted in a reluctance to challenge the fraudulent activities of Enron's senior executives.

Unfortunately, there exists general concern over the independence and effectiveness of NEDs for several reasons:

- As NEDs work part-time, they are unlikely to have sufficient time to become fully conversant with the company's business. Accordingly, they will likely rely on the executives to draw attention to what is important and the executives may be tempted to be selective in passing information onto the NEDs.
- Many NEDs are executives themselves for other companies. They may socialize with the executives they are tasked with monitoring and, as a result, it has been argued that many NEDs share the executives' ideologies and are likely to pull their punches for fear of encouraging their own NEDs to monitor critically.
- (p. 113) The appointment of NEDs is a cause for concern. Although the appointment of directors of listed companies is meant to be led by a nomination committee consisting of a majority of independent NEDs, the Higgs Report noted that the nomination committee is often the 'least developed of the board's committees'. There is also a widespread belief that the CEO of the company will often play a significant behind-the-scenes role in selecting the nominees, thereby diminishing the committee's independence.

> ### Revision tip
>
> In an essay question concerning the effectiveness of NEDs, it is crucial that you discuss the importance of independence, the extent to which NEDs are actually independent in practice, and how a lack of independence can affect a NED's ability to perform effectively.

> ### Key debates

Topic	**Executive remuneration**
Author/Academic	Financial Reporting Council
Viewpoint	Discusses corporate governance developments in 2013 in relation to the impact and implementation of the **UK Corporate Governance Code** and the **UK Stewardship Code**, as well as setting out the FRC's plans for the future in relation to these codes.
Source	*Developments in Corporate Governance 2013* (FRC 2013), available from https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Developments-in-Corporate-Governance-2013.pdf
Topic	**Non-executive directors**
Author/Academic	Derek Higgs
Viewpoint	Discusses the importance, role, and effectiveness of NEDs and makes a number of recommendations (many of which have since been incorporated into the **UK Corporate Governance Code**) aimed at improving their effectiveness.
Source	*Review of the Role and Effectiveness of Non-Executive Directors* (DTI 2003)—available from www.bis.gov.uk/files/file23021.pdf

Exam questions

Essay question

> 'The effectiveness of the corporate governance recommendations contained in the UK Corporate Governance Code is heavily dependent upon the ability of the non-executive directors. (p. 114) Unfortunately, non-executive directors are subject to numerous limitations that render them a largely ineffective corporate governance mechanism.'

Discuss the validity of this statement.

See the Outline answers section in the end matter for help with this question.

Problem question

Skyweb plc is a large company specializing in software research. Its board consists of ten directors, six of whom hold executive office, with each director requiring re-appointment every four years. The company's shares have been listed on the London Stock Exchange for the last two years.

The company decides to expand its board by appointing two new directors, one of whom will be a non-executive director. The board's nomination committee, which consists of three non-executives and two executives (one of whom is the company's Chairman), nominates several candidates to be put to the general meeting.

Unfortunately, one member of the nomination committee did not contribute to the committee's work, as he was recently appointed for the first time to the office of director and had not yet received any training on his roles and responsibilities.

The company has made a handsome profit. Accordingly, the executives believe that all the directors of the board should receive a 25 per cent pay rise. The pay increase is agreed upon at a meeting of the entire board. The remuneration of all the directors consists solely of a base salary and the directors' service contracts are two years in length.

Several large institutional investors have expressed concern over the competence of the company's auditor. Accordingly, it is decided that Skyweb will appoint a new auditor. John, the CEO and Chairman, has a friend of his who has a reputation for being a very competent and thorough auditor. Accordingly, John convinces the board that his friend should be nominated. The appointment is confirmed by the company at the AGM. The newly-appointed auditor also provides additional non-audit services to the company as and when required.

Adam is considering purchasing a substantial number of shares in Skyweb. However, he is concerned about the company's commitment to good corporate governance practices and, based on these events, he asks for your advice regarding any examples of poor corporate governance practices that the company might have engaged in.

Online Resource Centre

To see an outline answer to this question log on to www.oxfordtextbooks.co.uk/orc/concentrate/

Law Trove

Company Law Concentrate: Law Revision and Study Guide (3rd edn)

Lee Roach

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8. Capital and capital maintenance

Chapter: (p. 115) 8. Capital and capital maintenance
Author(s): Lee Roach
DOI: 10.1093/he/9780198703808.003.0325

Key facts

• The two principal types of capital that companies acquire are share capital (capital obtained by selling shares) and debt capital (capital borrowed from others).

• A new allotment of shares must usually first be offered to existing shareholders.

• Companies are prohibited from allotting shares for less than their nominal value.

• Companies can issue different classes of shares with different class rights, and the law regulates the ability to vary such class rights.

• Public companies are subject to minimum capital requirements when commencing business, whereas private companies are not.

• A reduction of share capital is only valid if the strict procedures relating to a reduction of capital found in the Companies Act 2006 are complied with.

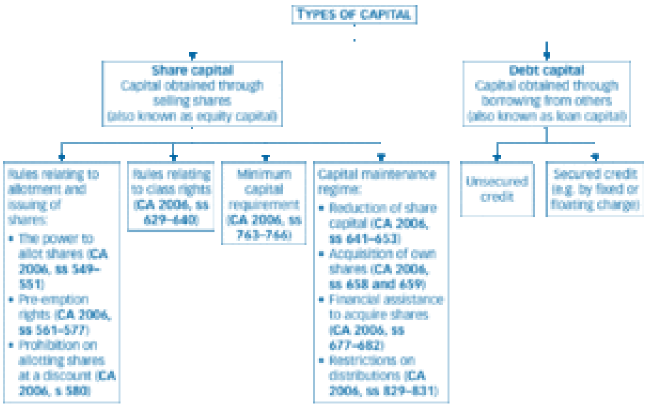
• Companies are generally prohibited from purchasing their own shares, but the 2006 Act does provide exceptions to this prohibition.

• Private companies are permitted to provide financial assistance to acquire their own shares. Public

companies are generally prohibited from providing such assistance, but there are exceptions.

- Companies can only pay a dividend out of 'profits available for the purpose'.
- The two principal types of charge are fixed charges and floating charges and, in order to be enforceable, charges need to be registered in accordance with the Companies Act 2006.

(p. 116) Chapter overview



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(p. 117) Shares and share capital

Section 540(1) of the CA 2006 defines a 'share' as a 'share in the company's share capital', but this definition fails to fully articulate the true nature of a share. A share is an item of property (**CA 2006, s 541**) known as a 'thing in action'. In a legal sense, a 'thing' (formerly known as a 'chose') is simply an item of property other than land, and a thing in action is simply an intangible thing which, being intangible, can only be claimed or enforced by legal action, as opposed to taking possession of it. Being intangible, a share has no physical existence, but instead confers a number of rights and liabilities upon its holder, including providing evidence of the existence of a contract between the shareholder and the company (this contract is discussed at p 49, 'The constitution as a contract'). It is important to note that share ownership does not give the shareholder a proprietary right over the assets of the company (***Borland's Trustee v Steel Bros & Co Ltd*** **[1901]**), as the assets belong to the corporate entity.

Classifications of share capital

The capital that the company acquires through the selling of shares is known as 'share capital' or 'equity capital'. The law relating to share capital is terminology heavy, so our discussion will begin with an exposition of some terminology that you will encounter.

Nominal value

All shares in a limited company with a share capital are required to have a fixed 'nominal value' and failure to attach a nominal value to an allotment of shares will render that allotment void (**CA 2006, s 542(2)**). The nominal value is a notional value of a share's worth but, in reality, it may bear no resemblance to a share's actual value. The nominal value of a share represents the minimum price for which the share can be allotted and, as is discussed at p 12, 'Limited and unlimited companies', it also helps in determining the liability of a shareholder in the event of the company being liquidated. Whilst shares cannot be allotted for less than their nominal value, it is common for shares to be allotted for more than their nominal value and the excess is known as the 'share premium' (i.e. the share premium represents the difference between the nominal value and the market value of the share).

Authorized share capital

The concept of authorized share capital has been abolished by the **CA 2006** but it is still of relevance. Under the **CA 1985**, companies were required to state in their memoranda the total nominal value of shares that may be allotted by the company, and this value represented the company's authorized share capital. Accordingly, a company with an authorized share capital of £1 million could not allot shares with a combined nominal value of more than £1 million. For example, it could allot a million shares with a nominal value of £1, or 500,000 shares with a nominal value of £2, and so on.

(p. 118) Looking for extra marks?

Essays often require you to critically evaluate law reforms and there is little doubt that the abolition of the concept of authorized share capital is a beneficial reform. You should be aware of the two principal reasons why the concept of authorized share capital was abolished. First, many companies would simply choose an arbitrary and inflated figure, confident that it would never be reached. Second, even if that figure was reached, the company could increase the authorized share capital by simply passing an ordinary resolution.

Companies incorporated under the **CA 2006** are not limited in terms of the number of shares they can issue (unless they choose to state an authorized share capital in their memoranda). However, companies incorporated under the **CA 1985** may still have their authorized share capital stated in their memoranda and, as regards such companies, their ability to allot shares will be limited to the amount stated.

Issued and unissued share capital

A company's authorized share capital represents the total nominal value of shares that *can* be allotted. The total nominal value of shares that actually *has* been allotted is known as the 'issued share capital'. So, for example, a company that has allotted three million shares that have a nominal value of £5 each would have an issued share capital of £15 million. The difference between a company's authorized share capital and its issued share capital (i.e. the nominal value of shares that could still be issued) is known as the 'unissued share capital'. With the abolition of authorized share capital, the concept of unissued share capital has also been abolished, except for those companies that still state in their memoranda their authorized share capital.

Paid-up, called-up, and uncalled share capital

Shareholders may not have to pay fully for their shares upon allotment. Shares may be partly paid for when allotted, with the remainder to pay at a later date. The combined total of the nominal share capital that has actually been paid is known as the 'paid-up share capital'.

Example

BioTech plc has allotted and issued a million shares in total with a nominal value of £1 each (accordingly, its issued share capital is £1 million). The company allows allottees to pay 50 pence per share upon allotment and the remainder at a later date to be specified by the company. All of the million shares are allotted and purchased, and every shareholder pays 50 pence per share only. BioTech's paid-up share capital is therefore £500,000 (1 million shares × 50 pence).

If shares are partly paid for on allotment, the company can call for the remainder (or part of the remainder) to be paid, or the company might have required payment in instalments and an instalment has become due. The paid-up share capital plus the amount called for or the instalment due is known as the 'called-up share capital'.

(p. 119) Example

Following on from the previous BioTech example, the company calls for 25 pence per share on all unpaid shares to be paid. This will result in a total of £250,000 (1 million shares × 25 pence) becoming due. Accordingly, the called-up share capital will be £750,000 (i.e. £500,000 (paid-up share capital) + £250,000 (the amount that has been called upon)). Note that the amount called for forms part of the called-up share capital irrespective of whether it is actually paid or not.

The difference between the company's issued share capital and its called-up share capital is known as the 'uncalled share capital' (i.e. the amount remaining to be called upon by the company).

The allotment and issuing of shares

There are two principal methods by which a person can become a shareholder in a company:

1. he can become a shareholder by purchasing new shares from the company, or
2. as shares are freely transferable items of property (subject to any limitations found in the articles), he can become a shareholder by obtaining shares (through sale, gift, bequest, etc.) from an existing shareholder.

Exam questions in this area usually relate to the company's ability to allot and issue shares and so this section of the chapter will focus on the first method. It is worth noting that, whilst the terms 'allotment' and 'issue' tend to be used interchangeably, there is a distinction, namely:

- Shares are *allotted* 'when a person acquires the unconditional right to be included in the company's register of members in respect of the shares' (**CA 2006, s 558**).
- Shares are *issued* when the person's name is actually entered into the register of members (***National Westminster Bank v IRC* [1995]**). From this, it follows that the issuing of shares takes place after they have been allotted.

The power to allot shares

The **CA 2006** lays down strict procedures regarding the allotment of shares and any director who knowingly permits or authorizes an unlawful allotment will commit an either way offence, although the allotment itself will remain valid (**CA 2006, s 549(4)–(6)**). Where a private company has only one class of share, the power to allot shares is vested in the directors, subject to any limitations found in the articles (**CA 2006, s 550**) (the model articles contain no such limitations). In all other cases, the directors can only allot shares if they are authorized to do so by the company's articles (the model articles do not contain such authorization) or by a resolution of the company (**CA 2006, s 551**).

(p. 120) Revision tip

When exercising the power to allot shares, directors are under a statutory duty to exercise this power for the purposes for which it was conferred (**CA 2006, s 171(b)**). As is discussed at p 69, 'Duty to act within the company's powers', many cases concerning this duty relate to the directors' power to allot shares, so you will need to be aware of the link between directors' duties and the power to allot shares, as a problem question may combine the two topics.

Table 8.1 sets out the rules relating to the allotment of shares.

Table 8.1 The power to allot shares

Type of company	**Power to issue shares**	**Provisions in the articles**
Private company with only one class of share that wishes to issue shares of the same class.	**Section 550 of the CA 2006** provides that the directors may allot shares of the same class, except to the extent that they are prohibited from doing so by the company's articles.	A provision in the articles empowering the directors to issue shares is not required, but the articles may limit the directors' power to issue shares (the model articles contain no such limitations).
Any other type of company, namely: • a private company with multiple classes of share; • a private company with only one class of share that wishes to issue a different class of share; a public company.	**Section 551 of the CA 2006** provides that the directors will only have the power to issue shares if: **a)** they are authorized to do so by the company's articles, or; **b)** the members pass a resolution authorizing the directors to issue shares.	The model articles for private companies limited by shares and the model articles for public companies provide that 'the company may issue shares with such rights or restrictions as may be determined by ordinary resolution'. Accordingly, under the model articles, the directors are not authorized to issue shares without the passing of an ordinary resolution.

Pre-emption rights

An inevitable consequence of a new allotment of shares is that the shareholdings of existing shareholders (and consequently, their voting power and the return on their investment) will be diluted. The allotment may even cause control of the company to be transferred to a new person. To prevent these consequences occurring without shareholder consent, existing shareholders are given a right of pre-emption, meaning that any new allotment of shares must first be offered to the existing shareholders (**CA 2006, s 561(1)**). If an allotment is made that contravenes the pre-emption rights of existing shareholders, then the allotment will remain valid, but the company and every officer who knowingly authorized the allotment will be liable to compensate the shareholders who would have benefited from the pre-emptive offer.

You should also remember that, in certain circumstances, the shareholders' pre-emption rights can be limited (e.g. where the shares allotted are bonus shares) or even completely **(p. 121)** excluded (e.g. where a private company has a provision in its articles excluding pre-emption rights).

Revision tip

Problem questions involving a company that allots shares to an outside party against the wishes of existing shareholders are reasonably common. Be prepared to discuss whether or not the pre-emption rights of the existing shareholders have been breached. Essay questions might focus on the effectiveness and rationale of the pre-emption rules. For an analysis of the law relating to pre-emption rights and a discussion of why such rights are needed, see Paul Myners, *Pre-Emption Rights: Final Report* (DTI 2005)—available from www.bis.gov.uk/files/file28436.pdf.

Prohibition on allotting shares at a discount

Section 580 of the CA 2006 provides that shares cannot be allotted at a discount (i.e. for less than their nominal value). Any contract that purports to allot shares at a discount is void and, if shares actually are allotted at a discount, the allottee is liable to pay the company an amount equal to the discount including interest. The company and every officer in default also commit an either way offence.

However, the effectiveness of the prohibition, at least in relation to private companies, is weakened by the fact that shares do not have to be paid for in cash. **Section 582(1) of the CA 2006** provides that shares can be paid for in 'money or money's worth,' and it is reasonably common for shares to be paid for in goods, property, by providing a service, or by transferring an existing business to the company in return for shares (as Mr Salomon did). By overvaluing the non-cash consideration, private companies can effectively issue shares at a discount. This problem would be lessened if the courts were regularly willing to monitor the value of non-cash consideration, but the courts have stated that they will only interfere where the consideration is manifestly illusory or inadequate (***Re Wragg Ltd* [1897]**). Accordingly, private companies can easily avoid the prohibition should they choose to do so.

Revision tip

In an exam question requiring you to evaluate the effectiveness of the rules relating to the allotment of shares, the ineffectiveness of the law to prevent private companies from issuing shares at a discount is a notable weakness you should discuss.

Regarding public companies, the rules are more stringent in two ways. First, public companies cannot accept payment for shares in the form of services (**CA 2006, s 585(1)**). Second, if a public company allots shares for non-cash consideration, then that consideration must be independently valued by a person eligible for appointment as the company's auditor (**CA 2006, ss 593 and 1150**). This person must confirm that the value of the non-cash consideration is at least equal to the amount paid up on the shares.

(p. 122) Classes of share

Most companies will only have one class of share (known as 'ordinary shares') and, in such companies, all the shareholders will have the same rights. However, providing that the articles so authorize (and the model articles do provide such authorization), a company is free to issue different classes of share that confer different rights upon the holder (e.g. shares with increased or decreased voting rights, or shares with differing nominal values). A common form of share class is the preference share, which will usually entitle the holder to some sort of benefit or preference over and above the ordinary shareholders. The exact nature of the preference will vary from company to company, but most preference shares provide their holders with fixed or preferential rights to a dividend, and/or priority claims on the assets of the company upon liquidation.

Variation of class rights

The rights attached to differing classes of shares are known as 'class rights' and shareholders of one class might attempt to remove the class rights of shareholders of another class (especially if the class rights confer a benefit upon the latter class of shareholders). The **CA 2006** provides that a variation of class rights will only be effective if

strict formalities are complied with. It is therefore important to know what constitutes a 'variation'. It is clear that abrogation (abolition) of a right will constitute a variation, but the courts are reluctant to hold that a mere alteration of a right will constitute a variation, as the following case demonstrates.

Re Mackenzie and Co Ltd [1916] 2 Ch 450 (Ch)

FACTS:

The company issued preference shares with a nominal value of £20 each. These shares entitled their owners to a 4 per cent dividend on the amount paid up and, as the shares were fully paid up, this equated to 80 pence per share. The articles were amended to reduce the nominal value of the preference shares to £12, thereby reducing the dividend to 48 pence per share.

HELD:

The alteration of the articles did not constitute a variation of a class right, as the right remained the same (i.e. 4 per cent of the amount paid up). Providing that the right itself remains the same, the fact that an alteration renders the right less valuable (or even worthless), will prevent the alteration from amounting to a variation.

Looking for extra marks?

Other cases that demonstrate the courts' reluctance to hold that an alteration amounts to a variation include ***Greenhalgh v Arderne Cinemas Ltd*** **[1951]** and ***White v Bristol Aeroplane Co Ltd*** **[1953]**. The courts' reluctance to hold that an alteration amounts to a variation must be regarded as a reduction of the protection afforded to shareholders who have had their class rights rendered less valuable.

(p. 123) **Sections 630 and 631 of the CA 2006** provide that class rights can only be varied in one of two ways:

1. if the company's articles contain a clause stating how class rights are to be varied, then a variation will be valid if it complies with that clause, or
2. if the company's articles do not contain a class rights variation clause, then a variation will be valid if it is (i) approved in writing by the holders of three-quarters in nominal value of the issued shares of the class in question, or (ii) approved by the passing of a special resolution at a meeting of holders of that class of share.

Minimum capital requirement

Private companies with a share capital are not subject to a minimum share capital requirement and can accordingly be set up by issuing a single 1 pence share to a single shareholder. Conversely, a public company cannot conduct business until it has been issued with a trading certificate and the Registrar of Companies will not issue such a certificate unless he is satisfied that the nominal value of the company's allotted share capital is not less than £50,000 (**CA 2006, s 763(1)(a)**).

This minimum capital requirement aims to ensure that there is always a minimum level of capital available in order to satisfy the company's debts. However, in reality, it is universally acknowledged that the minimum capital requirement does little to aid creditors for three reasons:

1. The figure of £50,000 is simply too low to offer creditors any real protection.
2. The shares do not even need to be fully paid up—only one quarter of the nominal value and the whole of the premium need be paid up at the time of allotment (**CA 2006, s 586(1)**), and shares issued at the time of incorporation must be paid for in cash. The result is that a newly formed public company may have only £12,500 in cash when it starts business (with the right to call on the shareholders for at least a further

£37,500).

3. The authorized minimum is measured at the time the company commences trading, but little account is taken of the fact that it may be reduced once trading commences. If the level of capital does fall below half the company's called-up capital, then a general meeting must be called to discuss what steps should be taken (**CA 2006, s 656(1)**), but by the time the assets reach this level, it is likely that some form of insolvency procedure will be in place, thereby rendering the general meeting useless. Even if this is not the case, the Act does not require that the meeting take any action.

Revision tip

Whilst the **CA 2006** might contain several useful reforms in relation to share capital, it has done nothing to improve the effectiveness of the minimum capital requirement. Be aware of the weaknesses in the law that the 2006 Act has failed, or been unable, to remedy. For a criticism of (p. 124) the minimum capital requirement, see Paul L Davies and Sarah Worthington, *Gower and Davies' Principles of Modern Company Law* (9th edn, Sweet & Maxwell 2012) 280.

Capital maintenance

Having obtained share capital through the selling of shares, the law requires that the company 'maintain' that capital by not distributing it in unauthorized ways. The rationale behind this requirement is one of creditor protection—it is to the company's capital that the creditors look to for payment and the less capital the company has the greater the risk will be that the company will default and the creditors will not be paid. At its most basic level, the creditors will expect capital to rise and fall in the course of trading, but will not expect the company to return capital to the shareholders. Accordingly, through a series of rules known collectively as the 'capital maintenance regime', the law prohibits capital from being returned to the shareholders. These rules will now be discussed.

Revision tip

The capital maintenance regime is an important topic, and an exam question may require you to apply the rules to a set of facts (in the case of a problem question) or to discuss the effectiveness of the various rules or a single rule (in the case of an essay question). Alternatively, an essay question may focus on the effectiveness of the capital maintenance reforms contained in the **CA 2006**.

The restructuring of share capital

A company may seek to increase its share capital by allotting new shares. It may seek to subdivide its shares by taking existing shares and subdividing them into shares of a smaller nominal value, or it may wish to consolidate shares by merging existing shares into shares of a higher nominal value. These forms of share capital restructuring do not adversely affect the level of share capital and so creditor interests are not jeopardized. However, a reduction of share capital may adversely affect the creditors' interests, and so such reductions are heavily regulated. A reduction of capital will be unlawful unless the procedures found in **ss 641–653 of the CA 2006** are complied with. These sections provide companies with two methods to reduce share capital.

Looking for extra marks?

Be aware of how the law has changed in this area. The **CA 1985** provided that companies could only reduce capital if their articles so permitted, a special resolution was obtained, and the reduction was approved by the

courts. Obtaining court approval proved to be unduly burdensome for many smaller companies (not to mention increasing the courts' caseload), so the 2006 Act provides private companies with a method of reducing capital that does not require court approval. This is an undoubted benefit for smaller companies, although the lack of court approval may arguably result in less scrutiny of the reduction.

(p. 125) Special resolution and court confirmation

The first method of effecting a reduction of capital is available to all types of company and provides that a reduction will be valid where the company authorizes the reduction by passing a special resolution and the company then applies to the court for an order confirming the reduction (**CA 2006, ss 641(1)(b) and 645**). If a public company wishes to reduce its share capital below the authorized minimum discussed earlier (£50,000), then the Registrar of Companies will not register the reduction unless the company first re-registers as private, or unless the court so directs (**CA 2006, s 650(2)**).

Court confirmation provides a significant measure of creditor protection as the courts' principal concern will be the protection of the company's creditors. This is backed up by **s 646**, which provides certain creditors with the right to object to the reduction. However, the interests of shareholders are also taken into account and the court will aim to determine whether the reduction would be fair and equitable between different classes of shareholders and between shareholders of the same class (***Scottish Insurance Corporation Ltd v Wilsons & Clyde Coal Ltd*** **[1949]**).

Special resolution supported by solvency statement

The second method of effecting a reduction is available to private companies only and does not require court approval. A private company can effect a reduction of capital by passing a special resolution authorizing the reduction, supported by a statement of solvency from the directors (**CA 2006, ss 641(1)(a) and 642**). This statement must be made no more than 15 days before the resolution is passed and will provide that the directors have formed the opinion that:

- there is no ground on which the company could then be found to be unable to pay its debts, and
- the company will be able to pay its debts as they fall due during the year immediately following the date of the statement. If the company is to be wound up within 12 months of the statement being made, the directors must be of the opinion that the company will be able to pay its debts in full within 12 months of the winding-up commencing.

If the directors make this statement without reasonable grounds for the opinions expressed within it, every director who is in default commits an either way offence, although the reduction will remain valid.

The acquisition of own shares

The common law absolutely prohibited companies from purchasing their own existing shares on the ground that this would involve returning capital to the shareholders (***Trevor v Whitworth*** **(1887)**) and would therefore reduce the funds available to pay the creditors. **Section 658 of the CA 2006** maintains a strict approach by providing that limited companies cannot purchase their own shares, except in accordance with the procedures laid down in (p. 126) the **CA 2006**. If these procedures are not followed, the purported acquisition of shares is void, and the company and every officer of the company in default will commit an either way offence. A company can purchase its own shares in one of two ways.

Redeemable shares

A company can purchase shares that it has issued as redeemable shares (**CA 2006, s 684**). Redeemable shares offer temporary membership of a company and tend to provide that the shares can be redeemed (i.e. bought back) by the company, usually upon the insistence of the company or the shareholder, or after a stated period has passed. To ensure that capital is not reduced, the company must pay for the shares out of its distributable profits, or out of a fresh issue of shares (although a specific method does exist whereby private companies can redeem shares out of

capital).

Purchase by a company of its own shares

Whilst redeemable shares are useful, they are inflexible in so much as the company must decide, prior to issue, that the shares are to be redeemable and the company can only then purchase those redeemable shares. What companies wanted was the general ability to purchase any shares (including redeemable shares) and such a power exists under **s 690 of the CA 2006**. Several safeguards exist, including:

- Only limited companies may purchase their own shares.
- The shares purchased must be fully paid up and, when purchasing the shares, the company must pay for the shares upon purchase.
- Purchase of the shares must be made from distributable profits, or out of a fresh issue of shares (although there is a specific method whereby private companies can purchase their own shares out of capital).

Additional safeguards are provided depending whether or not the purchase is to take place on a recognized investment exchange. Basically, where the purchase is to take place on such an exchange, the additional safeguards imposed by the Act are less extensive as investment exchanges have their own safeguards in place.

Financial assistance to acquire shares

Since the **Companies Act 1928**, companies have been generally prohibited from providing financial assistance to another to purchase their shares on the ground that it would allow a company to manipulate its share price by providing assistance to others to purchase its shares. Exceptions did exist, but they were narrow and strictly regulated. The problem was that this prohibition served to prevent innocent and commercially beneficial transactions, especially ones involving private companies. Accordingly, as regards private companies, this prohibition has now been abolished. The general prohibition is still retained for public companies (**CA 2006, ss 678 and 679**).

(p. 127) Looking for extra marks?

A convincing justification for the prohibition has never been fully articulated by the courts. Arden LJ in ***Chaston v SWP Group plc*** **[2002]** stated that the prohibition existed to prevent the resources of a target company being used to assist a purchaser as this can, in turn, prejudice the interests of the creditors of the target or its members. However, this justification is not generally accepted by academics, especially since the abolition of the prohibition in relation to private companies. For a discussion of possible justifications and their weaknesses, see Eilis Ferran, 'Corporate Transactions and Financial Assistance: Shifting Policy Perceptions but Static Law' (2004) 63 CLJ 225.

The prohibition in relation to public companies is required by the ***Second EC Company Law Directive***, so it will continue to exist for the foreseeable future and you will want to be aware of its operation. Contravention of the prohibition constitutes an either way offence, and an agreement to provide unlawful financial assistance will be voidable.

Looking for extra marks?

Whilst the removal of the prohibition in relation to private companies is a welcome reform, and is a notable example of how the 2006 Act aims to simplify the law and reduce regulation in relation to private companies, the retention of the general prohibition for public companies is still problematic. Companies are regularly forced to seek legal advice to ensure that perfectly innocent transactions do not fall foul of the prohibition and the Company Law Review Steering Group estimated that companies spend around £20 million per year on legal

advice in this area.

If you are faced with a problem question in this area, you will need to discuss two issues. The first issue is to determine whether or not the public company has provided 'financial assistance'. **Section 677(1) of the CA 2006** defines financial assistance as financial assistance given by way of gift, guarantee, security, indemnity or loan, or any other financial assistance given which materially reduces the assets of the company giving the assistance. This definition of financial assistance is clearly quite wide, but the courts will not be bound by these words alone and will always take into account the commercial context of the case. As Hoffmann J stated in ***Charterhouse Investment Trust Ltd v Tempest Diesels Ltd* [1986]**:

> One must examine the commercial realities of the transaction and decide whether it can properly be described as the giving of financial assistance by the company, bearing in mind that the section is a penal one and should not be strained to cover transactions which are not fairly within it.

Having shown the financial assistance has been provided, the second issue to discuss is whether or not it is unlawful. Financial assistance will be unlawful, unless the **CA 2006** provides that the transaction in question is one to which the prohibition does not apply. Transactions not subject to the prohibition include distributions of the company's assets by way of dividend and reductions of share capital by way of special resolution.

(p. 128) Distributions

As discussed at p 71, 'Duty to promote the success of the company', directors are under a duty to promote the success of the company for the benefit of its members (**CA 2006, s 172**). The pro-member nature of such a duty indicates that the principal purpose of most commercial companies is to make a profit. Members will expect a share of the company's profits to be distributed to them, usually in the form of a dividend. Dividends are simply the distribution, usually in cash, of profits to the members, usually at a fixed amount per share. Accordingly, the more shares a member owns, the greater the dividend he will receive.

Revision tip

It is often incorrectly stated by students that members have the right to a dividend, but this is not the case. Until a dividend is declared or a company is wound up, companies are not under a legal obligation to distribute profits to their members (***Burland v Earle* [1902]**). However, a failure to pay a dividend can amount to unfairly prejudicial conduct (discussed at p 148, 'Unfairly prejudicial conduct') or can justify the winding up of a company on just and equitable grounds (discussed at p 153, 'The petition for winding up').

A dividend can only be paid if it is properly declared and authorized, and the process of declaration and authorization is a matter for the company's articles. The normal three-stage procedure (and the procedure found in the model articles) is shown in **Figure 8.1**.

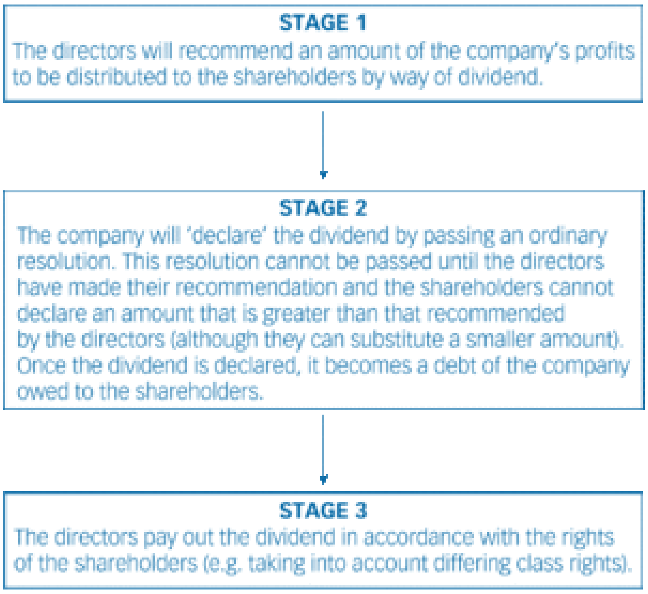

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Figure 8.1
The procedure for distribution of profits by way of dividend

(p. 129) Restrictions on distributions

In accordance with the general principle that capital should not be returned to the shareholders, **s 830(1) of the CA 2006** provides that companies cannot pay a dividend out of capital—instead a 'company may only make a distribution out of profits available for the purpose', with such profits being defined as the company's 'accumulated, realised profits … less its accumulated, realised losses' (**CA 2006, s 830(2)**). You need to understand the importance of the words 'accumulated' and 'realised':

- The word 'accumulated' is included to require companies to include previous years' losses when determining the profits available for the purpose. The aim of this is to prevent a situation whereby a company has several years' poor performance and sustains significant losses, but then has a profitable year and pays out a dividend, even though that profitable year has not replaced the losses suffered in previous years.
- The word 'realised' is included to prevent companies from paying out a dividend based on estimated profits. Companies used to be able to pay out a dividend based on estimated profits, but if that level of profit were not reached, the shortfall would have to be paid out of capital. Companies are now required to determine profits based on gains and losses that are realized, and what is realized is to be determined using generally accepted accounting principles, with the Financial Reporting Standard 18 providing that profits are realized only when realized in the form of cash or other assets, the cash realization of which can be assessed with reasonable certainty.

Looking for extra marks?

For a debate concerning the effectiveness of the requirement for profits to be realized, see Ralph Instone, 'Realised Profits: Unrealised Consequences' [1985] JBL 106, and Christopher Noke, 'Realised Profits: Unrealistic Conclusions' [1989] JBL 37.

When determining whether or not a distribution is lawful, the courts will focus on the purpose and substance of the transaction, as opposed to its form (e.g. a distribution described as a dividend, but paid out of capital, would be found unlawful, despite the label attached to it). Although the courts favour an objective approach, the courts will look at all the facts, which can include the state of mind of the persons orchestrating the transaction (***Progress Property***

***Co Ltd v Moorgarth Group Ltd* [2010]**).

Consequences of an unlawful distribution

The **CA 2006** provides only for one consequence following an unlawful distribution, namely that any shareholder who, at the time of the distribution, knew or had reasonable grounds to believe that the distribution was unlawful, is required to repay it, or part of it, to the company (**CA 2006, s 847(1) and (2)**). Under the common law, the directors who authorized the distribution are liable to repay the money to the company if they knew or ought to have **(p. 130)** known that the distribution was unlawful (***Re National Funds Assurance Co (No 2) (1878)***). This is a severe deterrent, as was seen in the case of ***Bairstow v Queens Moat Houses plc* [2001]** where the directors were required to pay back an unlawful distribution of £26.7 million, plus an additional £15.2 million in interest. If an unlawful distribution is made based on erroneous accounts, the company's auditor, if negligent in failing to detect the error, will be liable to repay the company the amount of the unlawful distribution (***Leeds Estate Building and Investment Co v Shepherd (1887)***).

Whilst this rule is clearly designed to protect the company's creditors, it should be noted that a company's creditors do not have legal standing to restrain an unlawful distribution (***Mills v Northern Railway of Buenos Ayres Co (1870)***), although they can petition the court to have the company wound up.

Debt capital

It may be the case that a company can acquire all the capital it needs through the selling of shares. However, in many companies, this will not be the case and the company will need to obtain additional capital by borrowing it from others. Such capital is known as 'debt capital' (or 'loan capital'), and can be obtained in several ways including making use of an overdraft facility, obtaining a loan from a bank, or mortgaging the property of the company.

The document by which a company creates or acknowledges a debt, whether secured or unsecured, is known as a 'debenture'. The word 'debenture' is commonly used to refer to secured debts, but **s 738 of the CA 2006** clearly indicates that debentures can be secured or unsecured. Companies can often raise significant amounts of debt capital by issuing debenture stocks, which are similar to shares except that a holder of debenture stock is a creditor and not a member, and therefore is entitled to interest on the loan, but will not receive a dividend.

Whilst not a legal requirement, a prudent lender may insist on having some form of claim upon the assets of the company, so that if the company defaults on the loan, the lender can seize the relevant assets and sell them in order to satisfy the debt owed. Where the loan agreement provides the lender with such a claim over the company's assets, the loan is said to be 'secured'. A further benefit of taking security is that, in the event of the company being liquidated, secured creditors have the right to be paid before the unsecured creditors (the distribution of a company's assets upon liquidation is discussed at p 170, 'Distribution of assets'). Given that insolvent companies will have limited assets, this is an extremely important advantage. There are many different forms of security, but the most common form of corporate security (and the one that tends to appear in company law exams most often) is the 'charge'.

Charges

Any form of security where possession of property is not transferred will be classified as a charge. The creditor who obtained the charge is called the 'chargee' and the borrower who granted the charge is known as the 'chargor' or 'surety'. There are two principal types of charge you need to be aware of, namely the fixed charge and the floating charge.

(p. 131) Revision tip

Charges often arise in problem questions concerning insolvency law (discussed in chapter 10), where a company that has entered some form of liquidation or rescue procedure will have granted a charge to a creditor.

The outcome of the case and the advice you offer will depend heavily on the type of charge concerned, so it is important that you are aware of the differences between fixed and floating charges.

Fixed charges

The simplest form of charge is the fixed charge, so called because it is taken over a fixed, identifiable asset of the company, such as a building, a vehicle, or a piece of machinery. Should the debtor company default on the loan, the creditor can look to the charged asset to satisfy the debt, usually by selling it and recovering the proceeds of sale. The most straightforward and common example of a fixed charge is a mortgage, whereby the debtor company (the mortgagor) will borrow capital from the creditor (the mortgagee) and the loan will be secured on a fixed asset of the company (e.g. a building). Should the company default on the loan, the creditor can obtain possession of the mortgaged asset and sell it.

Unless the charge contract provides otherwise, a company can grant multiple fixed charges over a specific asset, with prior charges having priority over subsequent ones (unless the terms of the prior charges provide that subsequent charges can be made that take priority).

Looking for extra marks?

Be aware of the advantages and disadvantages of using fixed charges. From the creditor's point of view, fixed charges are extremely useful as they allow the creditor to take security over a fixed, identifiable asset and ensure that the creditor ranks ahead of all other creditors in the event of the company being liquidated. Further, the charge contract will usually limit the debtor's ability to deal with the charged asset (e.g. the debtor will usually not be allowed to dispose of assets covered by a fixed charge). This makes the fixed charge a powerful form of security, but it also makes it inflexible, in so far as the debtor may wish to deal with the charged asset, but find himself unable to do so due to the existence of the fixed charge.

Floating charges

As noted, fixed charges can be inflexible as they limit the debtor's ability to use the charged asset. Accordingly, certain assets that fluctuate or assets that need to be used (e.g. raw materials) are not appropriate subjects of a fixed charge. A more flexible form of charge was therefore required, leading to the creation of the floating charge.

Revision tip

Essay questions on floating charges typically focus on the advantages and disadvantages that floating charges have over fixed charges. Problem questions involving floating charges tend to arise as part of a problem question involving another legal topic. For example, problem questions concerning insolvency law may feature an insolvent company that has assets subject to a floating charge.

(p. 132) There is no legal definition of what amounts to a floating charge, but in ***Re Yorkshire Woolcombers' Association Ltd* [1903]**, Romer LJ identified three factors that will indicate a charge is a floating charge:

1. the charge will be taken over a class of assets (e.g. machinery, raw materials, or even the entire undertaking), as opposed to a specific asset,
2. the class of assets charged is normally constantly changing (e.g. raw materials will be used and replenished), and
3. floating charges leave the company free to use and deal with those assets.

The third factor is what provides the floating charge with its flexibility. A floating charge 'floats' over the charged assets, but is not fixed on them, so the company is free to use and dispose of those assets. The company can even grant fixed charges on the assets over which the charge floats, which may (depending on the terms of the floating charge) rank ahead of the floating charge (***Wheatley v Silkstone and Haigh Moor Coal Co* (1885)**). However, the company cannot create a subsequent floating charge over the exact same class of assets as a prior floating charge, unless the first chargee agrees. The company can, however, create subsequent floating charges over part of the assets charged by a prior floating charge and the general rule is that later charges rank behind earlier ones (although the terms of the first charge may provide otherwise).

Upon the occurrence of certain events, the charge will cease to float and will become affixed to the charged assets, whereupon the company's ability to deal with the charged assets will be limited (this process is known as 'crystallization'). Certain events will always cause a charge to crystallize, including:

- the company going into liquidation
- the appointment of an administrator or a receiver
- an event that a clause (known as an 'automatic crystallization clause') in the security contract specifies as causing automatic crystallization.

Looking for extra marks?

Floating charges clearly have advantages over fixed charges, but floating charges also suffer from notable disadvantages that you should be aware of, including:

- Upon winding up, floating charges rank behind preferential debts (discussed at p 171, 'Preferential debts').
- A floating charge attaches only to the class of assets charged. Accordingly, if the charged assets have been dissipated, or are subject to a retention of title clause, there will be no assets for the charge to fix upon.
- **Section 245 of the Insolvency Act 1986** (discussed at p 170, 'Avoidance of floating charges') provides that, in certain cases, a floating charge can be avoided**.**

Table 8.2 makes clear the differences between fixed and floating charges.

Table 8.2 The differences between a fixed charge and a floating charge

	Fixed charge	Floating charge
Legal or equitable?	Can be legal or equitable	Equitable only
Subject matter of charge?	Usually taken over a specific, identifiable asset or assets	Usually taken over a class of assets, or the entire undertaking
Effect on the charged asset(s)?	The ability of the chargor to deal with the charged asset will usually be limited	The chargor will usually be free to deal with the charged assets
Better suited for which assets?	Better suited for assets that the company does not need to deal with or dispose of	Suitable for all types of assets
Priority?	Ranks ahead of all other debts	Ranks behind fixed chargeholders, liquidation expenses and preferential creditors
Reliant on liquidator?	Not reliant on the liquidator. Fixed chargeholders can obtain the charged asset and sell it to satisfy the debt owed	Floating chargeholders are reliant on the liquidator to obtain satisfaction of their debt
Set aside by liquidator?	A liquidator has no power to set aside a fixed charge	A liquidator has the power to set aside certain floating charges

(p. 133) Determining the class of charge

It is clear that there are significant differences between fixed and floating charges, with each form of charge having its own advantages and disadvantages. Identifying whether a particular charge is fixed or floating is not always straightforward and a charge holder may use this ambiguity to his advantage (e.g. by creating a charge with the characteristics of a floating charge, but later arguing that it is in fact a fixed charge in order to gain priority upon liquidation). Accordingly, the approach the courts use in determining whether a charge is fixed or floating is of crucial importance, and a substantial body of case law has developed in this area.

In ***Agnew v Commissioner for Inland Revenue*** **[2001]** (also known as ***Re Brumark***) the Privy Council stated that the process for determining the classification of a charge is twofold:

1. The court will look at the charge instrument in order to determine the rights and obligations that the parties intended to grant each other—it is not the task of the court to determine what type of charge the parties intended to create.
2. The courts will use these rights and obligations to determine, as a matter of law, whether the charge was fixed or floating.

As the courts are not concerned per se with the type of charge that the parties intended to create, it follows that the courts will not regard the parties' own classification of the charge (p. 134) as conclusive (***Street v Mountford*** **[1985]**) and will contradict the parties' classification if the rights and obligations imposed by the charge are not consistent with the label that the parties have attached to it (see e.g. ***Russell Cooke Trust Co Ltd v Elliott*** **[2007]**

where the High Court held that a charge that was described in the charge instrument as a floating charge, was in fact a fixed charge). In the following case, the House of Lords held that, in determining the class of charge as a matter of law, the courts should be led by 'the commercial nature and substance of the arrangement'.

Re Spectrum Plus Ltd [2005] UKHL 41

FACTS:

A company obtained an overdraft facility from a bank, with the bank taking what was purported to be a fixed charge over the company's **book debts** as security. The charge required that the company could not sell, charge, or assign the book debts without the bank's consent, and that the proceeds of the book debts were to be paid into the bank account that the company held with the bank. The company was, however, free to draw upon the account, providing that the overdraft facility was not exceeded. The company entered liquidation and, in order to determine the priority of the company's creditors, the court had to determine whether the charge was fixed or floating.

HELD:

The House held that the charge was a floating charge. Lord Scott stated that the key feature of a floating charge was that it grants the chargor (the company) the right to use the charged asset, including removing it from the scope of the charge. As the company could draw from the bank account, the rights granted to the chargor indicated strongly that the charge was a floating charge.

Looking for extra marks?

Re Spectrum Plus Ltd is a seminal case. For a lucid analysis of the decision of the House in this case, see Richard Nolan, 'A Spectrum of Opinion' (2005) 64 CLJ 554.

Registration

For obvious reasons, prior to providing a company with capital, a potential creditor will want to know of any charges over the company's assets. Accordingly, successive Companies Acts have long provided for a system of registration of charges. It should be noted that the law in this area has changed significantly following **Pt 25, Ch A1 of the CA 2006**, which came into force in April 2013. Prior to that date, the law relating to registration was deemed to be overly complex and the new rules simplify notably the registration system.

Prior to April 2013, the parties to a charge were required to register it and a limited company was under a legal obligation to maintain, at its registered office, a register of charges. Failure to comply with these rules constituted a criminal offence. The new system does not require mandatory registration of charges by the parties, nor does it require the company to maintain a register of charges. Instead, **s 859A of the CA 2006** provides that if any person interested in a charge registers, at Companies House, within the period allowed for delivery, a statement of particulars relating to the charge, then the Registrar of Companies must register the charge. The company or any other party interested in the charge may register the charge, but the registration will (p. 135) only be effective if it is made within the 'period allowed for delivery', which is 21 days beginning on the date of the creation of the charge (**CA 2006, s 859A(4)**). Upon successful registration, the Registrar will issue a certificate that will provide conclusive evidence that the statement of particulars was delivered to the Registrar within the period allowed for delivery.

As noted, prior to April 2013, companies were under an obligation to maintain a register of charges. However, the failure to maintain a register did not affect the validity of the charge concerned and criminal prosecutions were rarely sought. Accordingly, the requirement to maintain a register has been abolished, but **ss 859P and 859Q** require

companies to keep copies of any charge instrument capable of registration and to make such documents available for inspection. Under the **CA 1985**, only members and creditors were able to inspect the register of charges, but **s 859Q** provides any person with a right to inspect the charge instrument.

Looking for extra marks?

Be prepared to discuss the new system of registration. At first, it may be thought that the abolition of the requirement placed on the parties to register a charge would be a significant step. However, the consequences of non-registration are so severe that, in practice, it is likely to be the case that the vast majority of registrable charges will be registered. If the statement of particulars relating to the charge is not registered at Companies House within the 21-day period (or such longer period as allowed by the courts), then the security afforded to the creditor by the charge will be void against a liquidator, administrator, or creditor of the company (**CA 2006, s 859H**). In other words, the creditor will still be owed the sum in question, but the secured status afforded by the charge will be lost.

Key debates

Topic	**The capital maintenance regime**
Author/Academic	John H Armour
Viewpoint	Discusses the effectiveness of the capital maintenance rules from an economic viewpoint and argues that certain restrictions imposed are haphazard and are not justified. Although this article was written prior to the passing of the **CA 2006**, many of the arguments raised are still extremely relevant.
Source	'Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law' (2000) 63 MLR 355.
Topic	**Prohibition on providing financial assistance to acquire shares**
Author/Academic	Eilis Ferran
Viewpoint	Discusses several cases concerning the prohibition on providing financial assistance to acquire shares. Argues that justifications for the prohibition are unsatisfactory and provides recommendations regarding how the prohibition should be limited.
Source	'Corporate Transactions and Financial Assistance: Shifting Policy Perceptions but Static Law' (2004) 63 CLJ 225.

 ### Exam questions

Essay question

‘Whilst the Companies Act 2006 has undoubtedly improved the overall effectiveness of the rules relating to share capital and capital maintenance, it has failed to remedy a number of significant pre-2006 weaknesses in the law.’

Discuss the validity of this statement.

See the Outline answers section in the end matter for help with this question.

Problem question

Milo Ltd was incorporated in November 2010 and has issued 5,000 shares, all with a nominal value of £1 each. The company’s two directors, Ceri and Ross, each own 1,000 shares. Theo, a local businessman, owns 2,000 shares and the remaining 1,000 shares are owned by a number of local investors.

Since it was incorporated, the company has run at a loss and has never made a profit. Theo believes that this is due to Ceri and Ross’s poor management of the company. He also believes that, with new management, the company could be extremely profitable. He therefore starts buying from the local investors the shares that they hold in Milo Ltd with a view to voting Ceri and Ross out of office.

Ceri and Ross discover Theo’s plan. Accordingly, they cause the company to issue 3,000 new shares and offer to sell them to their friend, Gabrielle. However, Gabrielle cannot afford to buy these shares, but she does offer to sell her car to Milo Ltd as part-payment for the shares. The car is only worth £1,500 but Ceri and Ross accept the car as part-payment providing that Gabrielle uses the voting rights attached to her shares to defeat any resolution that aims to remove Ceri and Ross from office. The remaining payment comes in the form of £500, which Gabrielle borrows from Milo Ltd.

Theo, realizing that his scheme to oust Ceri and Ross has failed, wishes to sell his shares, but he cannot find a buyer. Ceri tells Theo that Milo Ltd will purchase the shares. By now, Theo has 2,500 shares, which he agrees to sell to Milo Ltd. The company purchases the shares and they are duly cancelled. Having rid themselves of the troublesome Theo, Ceri and Ross recommend that a dividend be paid at a rate of 10 pence per share. Gabrielle agrees and between them, the dividend is declared and paid out.

Discuss the validity of Ceri and Ross’s actions.

Online Resource Centre

To see an outline answer to this question log onto www.oxfordtextbooks.co.uk/orc/concentrate/

Law Trove

Company Law Concentrate: Law Revision and Study Guide (3rd edn)

Lee Roach

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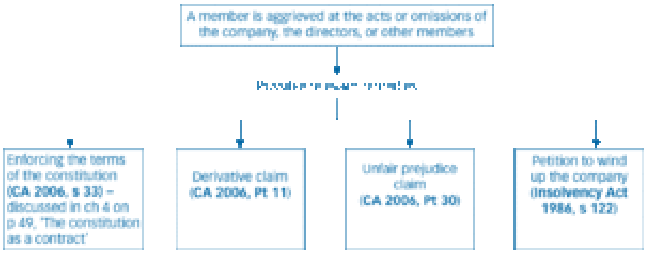
9. Members’ remedies

Chapter: (p. 137) 9. Members’ remedies
Author(s): Lee Roach
DOI: 10.1093/he/9780198703808.003.0384

Key facts

- Where a member is aggrieved due to the actions of the company, its directors or other members, he may be able to petition the court for a remedy.
- The rule in *Foss v Harbottle* provides, *inter alia*, that, generally, a member cannot commence proceedings to redress a wrong done to the company.
- In certain circumstances, the Companies Act 2006 allows members to commence proceedings for wrongs sustained by the company, via a derivative claim.
- A member can petition the court for a remedy where his interests have been unfairly prejudiced.
- A member can petition the court for an order winding up a company, and the court can grant such an order if it thinks it just and equitable to do so.
- The court will not order a winding up where an alternative remedy exists, and the claimant is acting unreasonably in not seeking that alternative remedy.

(p. 138) Chapter overview



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(p. 139) Introduction

The previous chapters have discussed several methods by which the law protects the members of a company. However, problems arise where the company or the members are wronged by the acts or omissions of the directors or majority shareholders. In such cases, the persons who cause the harm are also the persons who have standing to obtain redress. Without the law's aid, members, especially minority shareholders, who sustain loss due to the actions of the directors or majority shareholders would be left without a remedy. Accordingly, statute provides members with three principal remedies, namely:

1. The derivative claim under **Pt 11 of the CA 2006**.
2. The unfair prejudice remedy under **Pt 30 of the CA 2006**.
3. The petition for winding up the company under **s 122 of the Insolvency Act 1986 (IA 1986)**.

In addition, where the constitution of the company has been breached, a member may be able to enforce the provision that was breached or obtain a remedy for breach of contract. This has already been discussed (at p 49, 'The constitution as a contract') and so will not be discussed further.

Revision tip

It should be noted that the member remedies discussed in this chapter are not mutually exclusive and there exists a significant overlap between all three. Indeed, it is common for problem questions to require you to discuss multiple remedies, and to identify which remedy is more appropriate and/or would be more likely to succeed. Note, however, that in some cases, the courts have sought to lay down rules regarding the relationship between the various remedies, especially where the petitioner is seeking a court order to wind up the company.

It is worth noting that in ***Fulham Football Club (1987) Ltd v Richards* [2011]**, the Court of Appeal stayed an unfair prejudice claim (the unfair prejudice remedy is discussed at p 148, 'Unfairly prejudicial conduct') on the ground that FA Rules (by which the claimant was bound) provided that disputes should be referred to arbitration before commencing legal proceedings. The effect that such a clause would have on other member remedies is not yet known (although it is well established that an arbitration clause contained within the articles can form part of the **CA 2006, s 33** statutory contract (see p 49, 'The constitution as a contract')), but the general nature of the Court's discussion indicates that the *ratio* could indeed apply to the other remedies discussed in this chapter.

The derivative claim

If *A* sustains loss due to the actions of *B*, then generally only *A* can sue *B* to obtain redress. A third party (*C*) could not sue *B* on *A*'s behalf. As companies have separate personality, this principle applies equally in the corporate

context. If a company sustains loss due to the (p. 140) actions of another, then generally only the company can sue to obtain redress. However, where the company sustains loss due to the actions of its directors, problems arise in that the powers of the company are usually delegated to the directors, and this would include the authority to determine whether or not the company will commence litigation. Clearly, in such a case, the directors will not cause the company to initiate litigation against themselves. The question that therefore arises is can the members commence litigation on the company's behalf. Due to three principles known collectively as 'the rule in ***Foss v Harbottle***', the answer is generally no.

The rule in *Foss v Harbottle*

The rule in ***Foss v Harbottle*** is a cardinal principle of company law. In the case of ***Foss v Harbottle* (1843)**, the court established three principles:

1. The 'proper claimant' principle, which provides that only the company, and not the members, can commence proceedings for wrongs committed against it. This principle is a corollary of a company's corporate personality.
2. The 'internal management' principle, which provides that where a company is acting within its powers, the courts will not interfere in matters of internal management, unless the company itself commences proceedings. This principle is a corollary of the courts' long-established reluctance to become involved in the internal affairs of businesses.
3. The 'irregularity' principle, which provides that where some procedural irregularity is committed, an aggrieved member cannot commence proceedings where the irregularity is one that can be ratified by a simple majority of the members. This principle is a corollary of the principle of majority rule.

> Revision tip
>
> Remember that the irregularity principle applies both to rights vested in the company and to rights vested personally in the members. Accordingly, even where the right to commence proceedings is vested personally in a member, the member will be unable to commence proceedings if the members can ratify the irregularity by passing an ordinary resolution.

Derivative actions

The rule in ***Foss v Harbottle***, however, is not absolute. If it were, wrongs committed by the directors would rarely be subject to litigation. Accordingly, the courts crafted four so-called 'exceptions' to the rule ('so-called' because, as we shall see, only one is actually an exception), whereby members could commence an action on the company's behalf. Such actions were known as 'derivative actions' because the member was bringing an action based on rights derived from the company. This derivation is reinforced by the fact that, if the action succeeded, the remedy was granted to the company. With the creation of the statutory (p. 141) derivative claim, the derivative action was abolished, but knowledge of the common law exceptions will be of aid should an essay question require you to compare the common law derivative action to the statutory derivative claim. Four such exceptions existed, with the first three being simple and straightforward, namely:

1. Where the act complained of was illegal (***Taylor v National Union of Mineworkers (Derbyshire Area)* [1985]**) or *ultra vires* (***Simpson v Westminster Palace Hotel Co* (1860)**), a member could commence a derivative action.
2. Where the act infringed the personal rights of a member, a derivative action could be brought. Rights breached could include a failure to provide sufficient notice of general meetings, a failure to pay dividends in accordance with the articles, or the improper rejection of a member's votes.
3. Where the act complained of could only be done or sanctioned by the passing of a special resolution, a derivative action could be brought (***Edwards v Halliwell* [1950]**).

The fourth exception was more complex and was perhaps the most important, and occurred where those persons

who controlled the company had committed some sort of fraud on the minority. 'Fraud' included actual fraud (e.g. breach of the **Theft Act 1968** or the **Fraud Act 2006**) and equitable fraud (e.g. conduct tainted by impropriety). Negligence, even gross negligence, would not suffice (***Pavlides v Jensen*** **[1956]**), but where the negligence benefited those who controlled the company, this would suffice as the negligence would be tainted by impropriety (***Daniels v Daniels*** **[1978]**). The courts would not allow a claim based on fraud on the minority to succeed if it would not serve the interests of justice (e.g. where the independent members had indicated that they did not wish the claim to proceed (***Smith v Croft (No 2)*** **[1988]**).

Looking for extra marks?

If an essay question requires you to discuss the exceptions to ***Foss***, it is worth noting that fraud on the minority is the only true exception to the rule in ***Foss***. A true exception to ***Foss*** is one whereby a member enforces a right belonging to the company. In the cases of illegal/*ultra vires* acts, personal rights or acts requiring a special resolution, the right is actually vested personally in the member and so they are not true exceptions to ***Foss***.

The statutory derivative claim

Whilst the Law Commission agreed with the underlying approach of the rule in ***Foss v Harbottle***, it was of the opinion that the rules relating to derivative actions had become 'complicated and unwieldy'.

Revision tip

An essay question may require you to discuss the deficiencies of the rule in ***Foss v Harbottle*** and the rules relating to derivative actions, so ensure that you can critically analyse the rule and **(p. 142)** its exceptions. For a clear discussion of the rule, see Law Commission, *Shareholder Remedies* (Consultation Paper No 142, 1996) and Law Commission, *Shareholder Remedies* (Law Com Report No 246, 1997). Both can be obtained from www.lawcommission.justice.gov.uk.

The Law Commission therefore recommended that a statutory derivative claim be introduced, and this claim can now be found in **Part 11 of the CA 2006**.

Revision tip

Part 11 of the CA 2006 does not abolish the rule in ***Foss v Harbottle***— the rule itself retains much of its force. However, the common law derivative action has been abolished and replaced by the statutory derivative claim. Accordingly, in a problem question, make sure you apply the statutory rules and not the common law rules. Regarding essay questions, be prepared to discuss how the statutory derivative claim differs from the common law derivative action (as set out in Table 9.1), and whether the derivative claim provides a more effective source of member protection.

Table 9.1 The differences between the derivative action and the derivative claim

	Common law derivative action	**Statutory derivative claim**
Status?	The common law derivative action no longer exists	A derivative claim can only be brought under the **CA 2006**
Source of law?	Case law spanning over 150 years	**CA 2006, Pt 11**
Grounds for claim?	• Illegal/*ultra vires* acts • Acts which infringe personal rights of a member • Acts requiring a special majority • Acts which are a fraud on the minority	• Negligence • Default • Breach of duty • Breach of trust
Covers acts/omissions committed by?	Director(s) or member(s)	Director(s) only
Claim can be brought by?	A member only	A member, or a person who is not a member, but to whom shares have been transferred/transmitted by operation of law
Claim can be brought against?	A director of the company	A director of the company or another person (or both)
Claim for negligence?	Claim could only be brought if a director benefitted personally	Claim can be brought, irrespective of whether or not a director benefitted personally

(p. 143) Scope

Section 260(2) of the CA 2006 provides that a derivative claim can only be brought under **Pt 11** of the Act, or in pursuance of a court order under **s 994** (**s 994** is discussed at p XXX, 'Unfairly prejudicial conduct'). **Section 260(3)** provides that a derivative claim can only arise from an actual or proposed act or omission involving:

- *Negligence*—it will be remembered that negligence could not found a common law derivative action, unless the wrongdoer gained a benefit from the negligent act. This limitation has not been preserved by the **CA 2006**, leading many directors to fear an increase in the number of derivative claims (as is discussed later, this increase in claims has not occurred).
- *Default*— 'default' is a general term used in many pieces of legislation that refers to a failure to perform a legally obligated act (e.g. to appear in court when required).
- *Breach of duty*—a derivative claim can accordingly be founded on the basis of a breach of the general duties discussed at p 68, 'The general duties', as well as any other breach of duty.

- *Breach of trust*.

It will be noted that the scope of the statutory derivative claim differs substantially from the scope of the common law derivative action. In many respects, the scope of the derivative claim is wider, especially in relation to negligence and breach of duty.

Revision tip

If an essay requires you to discuss the differences between the common law derivative action and the statutory derivative claim, it is vital that you discuss the differences in scope of the two remedies. Ensure you are aware of how the scope of statutory derivative claim is wider and narrower than that of the common law derivative action.

The persons against whom a derivative claim can be brought have also been widened. Under the common law, a derivative action could only be brought against a director. A derivative claim, however, may be brought against a director or another person (or both) (**CA 2006, s 260(3)**). In one respect, however, the derivative claim is narrower, namely that the act or omission must be made by a director. Under the common law, the actions of members could found a derivative action, but this is no longer the case.

Revision tip

In problem questions, the identity of the wrongdoer will aid you in determining which remedy is relevant. Where a member has engaged in the wrongful act or omission, then a derivative claim cannot be brought and the appropriate remedy to discuss will likely be **s 994** (discussed at p 148, 'Unfairly prejudicial conduct'). Where the wrongdoer is a director, a remedy may be available under **s 994** or via a derivative claim. Note that the derivative claim itself need not be brought against the director (e.g. a claim could alternatively or also be brought against a member who was involved in the director's wrongful act or omission).

There is little doubt that, overall, the scope of the statutory derivative claim is broader than that of the common law derivative action. However, an important limitation on the use of derivative claims is the requirement to obtain, from the court, permission to continue the claim.

Permission from the court

Section 261(1) of the CA 2006 provides that a member who brings a derivative claim must apply to the court for permission to continue it, with **ss 261–264** establishing a two-stage process for determining whether permission should be granted. Under the first stage, the member must establish that he has a *prima facie* case. If the member cannot establish a *prima facie* case for permission, the court must dismiss the claim and can make any consequential order that it considers appropriate. If the member can establish a *prima facie* case, a hearing will be convened and the company will be directed to provide evidence. The purpose of this procedure is clearly to screen out unmeritorious or weak claims before the defendant becomes involved and, based on the cases to date, it is clear that establishing a *prima facie* case is not an overly difficult hurdle to overcome (this is borne out by the fact that virtually all derivative applicants have, since the **CA 2006** was introduced, successfully established a *prima facie* case).

Looking for extra marks?

In a number of cases to date, the defendant has conceded that, or decided not to contest that, a *prima facie* case existed. Given that it appears to be relatively easy to establish a *prima facie* case and a derivative claimant would be unlikely to commence a claim if it did not have such a case, it has been contended that the *prima facie* test does not serve a useful function and should therefore be abolished (it is worth noting that this stage was not part of the Law Commission's recommendation, but was added to the Act at a late stage in the House of Lords). Abolishing the *prima facie* stage could also reduce costs and encourage applicants to bring claims. Do you agree? For more, see David Gibbs, 'Has the Statutory Derivative Claim Fulfilled Its Objectives? A Prima Facie Case and the Mandatory Bar: Part 1' (2011) 32 Co Law 41.

If the member establishes that he has a *prima facie* case, then the court will move onto the second stage, under which it will decide whether or not to grant permission to continue with the claim. Key to the court's discretion to grant permission is **s 263**, with **s 263(2)** providing that the court *must* refuse permission if it is satisfied that any one of the following conditions applies:

- where a person acting in accordance with s **172 of the CA 2006** (duty to promote the success of the company for the benefit of its members—discussed at p 71, 'Duty to promote the success of the company') would not seek to continue the claim. This reinforces the fact that a derivative claim must be for the benefit of the company. Refusal of permission on this ground is likely to be rare, especially following the case of ***Iesini v Westrip Holdings Ltd*** **[2009]** where the court held that permission would only be (p. 145) refused on this ground if no director acting in accordance with **s 172** would seek to continue the claim
- where the cause of action arises from an act or omission that is yet to occur, that the act or omission has been authorized by the company
- where the cause of action arises from an act or omission that has already occurred, that the act or omission was authorized by the company before it occurred, or has been ratified by the company since it occurred (ratification is discussed at p 82, 'Relief from liability').

If the conditions found in **s 263(2)** do not apply, then **s 263(3)** provides the court with a non-exhaustive list of factors that it must take into account when determining whether or not to grant permission. Finally, **s 263(4)** provides that the court should have regard to the views of the members who have no personal interest in the matter. The company may have perfectly legitimate reasons for not pursuing a claim (e.g. waste of time and expense) and seeking the views of members with no interest in the matter may help the court to determine whether or not the claim should go ahead, even though the company may not wish it to. Figure **9.1** sets out the two-stage procedure for granting permission.

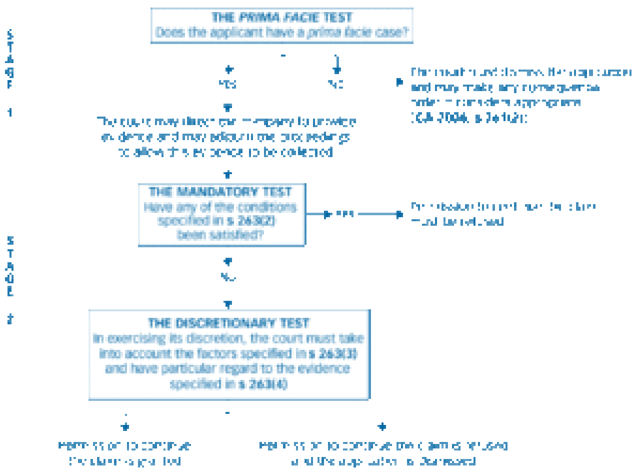

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Figure 9.1
The two-stage procedure to determine whether permission is granted

(p. 146) Revision tip

The need for permission from the court is a developing area of law that will have a significant impact upon the effectiveness of the derivative claim. In problem questions, students frequently forget to discuss the requirement for court permission. Ask yourself whether or not the facts of the problem provide any reasons why the court might refuse to grant permission. This is especially important if you are advising a potential derivative claimant. It is worth remembering that most derivative claims brought to date under the 2006 Act have failed because the court refused to grant permission to continue with the claim. For an excellent discussion of the permission procedure, see Andrew Keay and Joan Loughrey, 'Derivative Proceedings in a Brave New World for Company Management and Shareholders' [2010] JBL 151.

Early cases involving the requirement for court permission indicate that the courts' reluctance to allow common law derivative actions to proceed may still exist in relation to the statutory derivative claim (the case of ***Kiani v Cooper* [2010]**, heard in January 2010, was the first case under the **CA 2006** where the court permitted the claim to continue). One factor specified in **s 263(3)** that the court must take into account is the importance that a person acting in accordance with **s 172** would attach to continuing the claim. Several cases have focused on this factor and indicate that the views of a hypothetical director will often be a determining factor, as will the availability of a personal claim.

Mission Capital plc v Sinclair [2008] EWHC 1339 (Ch)

FACTS:

The defendants were two directors, whose service contracts provided that their employment could be immediately terminated if they engaged in unacceptable conduct. The claimant company terminated their employment on the grounds that they failed to submit financial information and failed to meet financial forecasts. The defendants disputed this. The claimant obtained an injunction that excluded the defendants from the claimant's premises. The defendants, *inter alia*, brought a derivative claim and sought permission to continue it.

HELD:

HELD: Permission to continue the claim was denied. Although the court believed that the defendants were acting in good faith, the court held that a notional director acting in accordance with **s 172** would not seek to continue the claim, as the damage suffered by the company was 'speculative'. Further, the court held that the defendants were not seeking anything that could not be recovered via a personal claim under **s 994 of the CA 2006** (discussed at p 148, 'Unfairly prejudicial conduct').

Looking for extra marks?

Many directors were concerned that the increased scope of the statutory derivative claim would result in a significant increase in the number of derivative proceedings than was the case under the common law. Clearly, this has not occurred and the number of derivative claims made has been low, with the majority of those claims that have been made being refused permission to continue to full trial, as Table 9.2 demonstrates. (p. 147)

Table 9.2 Permission granted and refused to continue a derivative claim

Cases where permission was granted	Cases where permission was refused
• *Re Fort Gilkicker Ltd* [2013] • *Hughes v Weiss* [2012] • *Phillips v Fryer* [2012] • *Parry v Bartlett* [2011] • *Stainer v Lee* [2010] • *Kiani v Cooper* [2010]	• *Re Singh Brothers Contractors (North West) Ltd* [2013] • *Bamford v Harvey* [2012] • *Ritchie v Union of Construction, Allied Trades and Technicians* [2011] • *Kleanthous v Paphitis* [2011] • *Re Seven Holdings Ltd* [2011] • *Cinematic Finance Ltd v Ryder* [2010] • *Iesini v Weststip Holdings Ltd* [2009] • *Stimpson v Southern Landlords Association* [2009] • *Franbar Holdings Ltd v Patel* [2008] • *Mission Capital plc v Sinclair* [2008]

The 'no-reflective loss' principle

An act or omission of a director may cause loss to both the company and, in turn, to its members (e.g. an act of negligence by a director causes the company loss, which in turn reduces profits and so lowers the members' dividends or the value of their shares). Such an act/omission might provide both the company and its members with a cause of action against the director. The company and the members might have a personal claim against the director, and/or the members might be able to bring a derivative claim against the director on behalf of the company. In such cases, the ability of the members to recover certain personal losses is limited by what is known as the 'no-reflective loss' principle. This basically states that, where the loss sustained by the members is reflective of the loss sustained by the company, then the members will not be permitted to recover those losses that are reflective of the company's loss that could be recovered by the company. In other words, in such cases, the company will be the proper claimant (which you may remember is the first principle of the rule in ***Foss v Harbottle***) and its claim will generally trump that of the members, as the following case demonstrates.

Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) [1982] Ch 204 (CA)

FACTS:

The directors had breached their duty by selling an asset of the company to a third party for less than it was worth, thereby causing the company loss. In order for the sale to be valid, the **Listing Rules** required the consent of the members, which the directors obtained by providing the members with misleading information regarding the sale. The transaction at an undervalue caused a reduction in the value of the company's shares. The members commenced a personal action against the directors.

HELD:

The members' claims were 'misconceived'. The loss suffered by the members was reflective of the loss suffered by the company, which could be recovered by the company by bringing a **(p. 148)** claim against the directors. In such a case, the company should bring the action and the members would not be permitted to recover the reflective loss.

The rationale behind the no-reflective loss principle is to prevent double-recovery. If both the company and the members could recover the loss, then the defendant would be forced to pay compensation twice. If a member were to be allowed to recover his loss at the exclusion of the company, then the company and its creditors would be harmed. Accordingly, as Lord Millett stated in ***Johnson v Gore Wood & Co (No 1)*** **[2002]**, '[j]ustice to the defendant requires the exclusion of one claim or the other; protection of the interests of the company's creditors requires that it is the company which is allowed to recover to the exclusion of the shareholders'.

Revision tip

Whilst the no-reflective loss principle may prevent personal claims from succeeding, it will not prevent a member from succeeding in a derivative claim. As the benefits of a derivative claim go to the company, no issue of double recovery arises and the company's creditors are not adversely affected. The no-reflective loss principle would not have prevented the members in ***Prudential*** from bringing a derivative claim although, in such cases, the courts still regard it as preferable for the company to recover its loss.

The no-reflective loss principle applies to any situation where the company and members have a cause of action deriving from the same facts, and not just where the members have a derivative cause of action. It can therefore apply in cases where the wrongdoer was not a director. For example, in ***Johnson v Gore Wood & Co*** **[2002]**, the wrongdoer was the company's firm of solicitors. The rule also applies where the company has decided not to commence proceedings. However, the principle will not apply where the defendant's actions leave the company unable to commence proceedings, such as where the defendant's actions cause the company such loss that it cannot afford to commence proceedings (***Giles v Rhind*** **[2002]**).

Looking for extra marks?

For a discussion of the no-reflective loss principle and the effects of ***Prudential***, ***Johnson***, and ***Giles***, see Charles Mitchell, 'Shareholders' Claims for Reflective Loss' (2004) 120 LQR 457.

Unfairly prejudicial conduct

Part 30 of the CA 2006 consists of a mere six sections, yet it contains what is perhaps the most important member remedy. **Section 994** allows a member to petition the court for a remedy on the ground that the company's affairs will be, are being, or have been conducted in a manner that is unfairly prejudicial to the interests of members generally, or of some part of its members (including at least that one member).

(p. 149) **Section 994** re-enacts almost identically **s 459 of the CA 1985**, so pre-2006 case law will still be highly relevant. **Section 459** was regarded as an extremely useful remedy, largely because of the courts' willingness to interpret it in a liberal manner. Key to the effectiveness of the remedy is how the courts interpret the phrases 'unfairly prejudicial' and 'interests of members'.

Revision tip

These two phrases also help establish the structure you should use when answering problem questions involving **s 994**, namely (i) is the conduct complained of unfairly prejudicial, and, if so (ii) is it unfairly prejudicial to the interests of the members? You may find it easier to first establish whether or not the facts of the problem concern interests that are recognized by **s 994** and, if so, then go on to discuss whether or not those interests have been unfairly prejudiced.

What are the 'interests of members'?

The conduct complained of must unfairly prejudice the 'interests of members', so the scope of the members' interests must be discussed. Historically, the courts would only grant a remedy where the petitioner was bringing the claim in his capacity as a member (i.e. his membership interests were unfairly prejudiced). Thus, where an employee of a company, who was also a member of the company, was dismissed by the company, the court refused to grant a remedy on the ground that the member had brought his claim in his capacity as an employee, and not in his capacity as a member (***Re John Reid & Sons (Strucsteel) Ltd* [2003]**). Where the conduct complained of has nothing to do with the petitioner's interests as a member, then a remedy under **s 994** will not be granted.

However, there is little doubt that the member *qua* member requirement has been interpreted broadly and has been extended to cover interests that are sufficiently close to the petitioner's interests as a member. In a series of cases, the courts have stated that, in certain companies known as quasi-partnerships (discussed at p 154, 'Quasi-partnerships'), the right to be involved in management may be regarded as a membership right. In the following case, the Privy Council held that loaning capital to a company is an interest that can be recognized under **s 994 of the CA 2006**.

Gamlestaden Fastigheter AB v Baltic Partners Ltd [2007] UKPC 26

FACTS:

Baltic Partners Ltd ('Baltic') was set up to operate a joint venture entered into by the claimant and a man named Karlsten. To finance the venture, the claimant made substantial loans to, and purchased a substantial number of shares in, Baltic. However, shortly thereafter, the claimant alleged that Karlsten and Baltic's directors had improperly removed funds from Baltic. The claimant alleged that this constituted unfairly prejudicial conduct and that Baltic's directors should account to Baltic for the withdrawals made. At the time of the hearing, Baltic had become insolvent, and so its directors argued that the payment of compensation to Baltic would benefit the claimant in his capacity as a creditor of Baltic, and so the claim should be dismissed.

(p. 150) **HELD:**

The court rejected the directors' arguments and found for the claimant. Lord Scott stated that, in such cases, the claimant should not be precluded from a remedy simply because the remedy would benefit him as a creditor and not as a member.

Looking for extra marks?

This case clearly demonstrates how far the courts will relax the member *qua* member requirement in order to achieve a just and equitable result. Further, as the claimant was apparently seeking to enforce a right that belonged to Baltic, one would assume that the rule in ***Foss v Harbottle*** would prevent the claim. This clearly demonstrates that a principal reason for the creation of the unfair prejudice remedy was to outflank the rule in ***Foss v Harbottle*** where fairness requires. For a discussion of this case, see Tony Singla, 'Unfair Prejudice in the Privy Council' (2007) 123 LQR 542.

Equitable considerations

Section 994 focuses on the members' interests as opposed to their rights. The members' rights are found in the company's constitution, but the courts have repeatedly stated that their interests can be wider than their rights. In

particular, in certain companies, the members may agree that the company should be run in a certain manner, but such agreements may never be formalized or inserted into the constitution. In such companies, the courts will not permit the constitution to be relied upon if such reliance unfairly prejudices the interests of the members by defeating the 'legitimate expectations' (since rephrased as 'equitable considerations') that such agreements give rise to. In ***O'Neill v Phillips*** **[1999]**, Lord Hoffmann stated that:

> A member of a company will not ordinarily be entitled to complain of unfairness unless there has been some breach of the terms on which he agreed that the affairs of the company should be conducted. But ... there will be cases in which equitable considerations make it unfair for those conducting the affairs of the company to rely upon their strict legal powers.

The approach established in this statement is demonstrated well by the facts of ***O'Neill v Phillips***.

O'Neill v Phillips [1999] 1 WLR 1092 (HL)

FACTS:

The defendant gave 25 per cent of a company's shares to the claimant and appointed him as a director. The defendant also retired from the board, leaving the claimant as the *de facto* managing director. The profits of the company were initially split 75:25 in favour of the defendant, but this was later amended to provide for an equal share. The company experienced financial difficulties and the defendant returned to oversee management. He also claimed to once again be entitled to 75 per cent of the company's profits. The claimant left the company and commenced an unfair prejudice claim.

HELD:

The House held that the defendant had not promised that the claimant would always receive 50 per cent of the profits and, at most, had promised that the claimant would receive **(p. 151)** 50 per cent of the profits only while he acted as *de facto* managing director. The defendant had not breached the company's constitution, nor was there anything giving rise to the equitable considerations of which Lord Hoffmann spoke. Accordingly, the claimant's action failed.

Looking for extra marks?

O'Neill v Phillips is a seminal case and was the only case involving unfair prejudice to ever reach the House of Lords. For a discussion of the case, see Dan D Prentice and Jennifer Payne, 'Section 459 of the Companies Act 1985: The House of Lords' View' (1999) 115 LQR 587.

What ***O'Neill*** establishes is that, in the majority of cases, the members' rights and interests will be the same and will be set out in the company's constitution. In other cases, however, notably those involving quasi-partnership companies (discussed at p 154, 'Quasi-partnerships'), equitable considerations will arise which can widen the members' interests beyond those rights found in the constitution. The category of equitable considerations is open-ended, but exclusion from management is a good example and is the issue that arises in most **s 994** cases. In most companies, the members will not expect to be involved in management, and so exclusion from management will not constitute unfairly prejudicial conduct. Conversely, in quasi-partnership companies, the members will usually expect to be involved in management, but such an expectation will usually derive from an informal agreement as opposed to the company's constitution. In such companies, exclusion from management will likely amount to unfairly prejudicial conduct.

When is conduct 'unfairly prejudicial'?

If the interest affected is one that is recognized by **s 994**, the next step is to discuss whether or not the company's affairs have been run in a way so as to unfairly prejudice that interest. The courts take an objective approach when determining whether or not the conduct complained of is unfairly prejudicial. Accordingly, there is no requirement for the petitioner to 'come with clean hands', but unmeritorious conduct on behalf of the petitioner might lead the court to hold that the conduct is not unfair, or that the remedy granted should be reduced (***Re London School of Electronics Ltd*** **[1986]**).

> Revision tip
>
> As Neill LJ stated in ***Re Saul D Harrison and Sons plc*** **[1994]**, the conduct complained of must be unfair *and* prejudicial. Bear this in mind when answering problem questions, as the conduct may be unfair but not prejudicial, or vice versa. For example, in ***Grace v Biagioli*** **[2005]**, the petitioner was a member and director of a company. He was removed from office because he was attempting to set up a rival company. The court held that the conduct complained of (i.e. removing him) was prejudicial but, given the obvious conflict of interest that his actions had created, it was not unfair.

(p. 152) The courts have repeatedly stated that the words 'unfairly prejudicial' are general words and are not to be given a narrow technical meaning. The courts have also not sought to establish a general standard or test to determine whether or not conduct is unfairly prejudicial. As Lord Hoffmann stated in ***O'Neill v Phillips*** **[1999]**, the rationale behind this is to 'free the court from technical considerations of legal right and to confer a wide power to do what appeared just and equitable'. He did, however, go on to say that what is fair would depend upon the context of the case adding that '[c]onduct which is perfectly fair between competing businessmen may not be fair between members of a family'. Accordingly, the individual facts of the case are all important.

Examples of conduct that the courts have held capable of being unfairly prejudicial include:

- non-payment of dividends (***Re a Company (No 00370 of 1987)*** **[1988]**) or payment of low dividends (***Re Sam Weller & Sons Ltd*** **[1990]**)
- exclusion from the management of a quasi-partnership company (***Re Ghyll Beck Driving Range Ltd*** **[1993]**)
- serious mismanagement (***Re Macro (Ipswich) Ltd*** **[1994]**). Note that the mismanagement must be serious—normal mismanagement will not normally constitute unfairly prejudicial conduct (***Re Elgindata Ltd (No 1)*** **[1991]**)
- preventing the members from obtaining the best price for their shares (***Re a Company (No 008699 of 1985)*** **[1986]**)
- the payment of excessive remuneration to the directors (***Re Cumana Ltd*** **[1986]**)
- the improper transfer of assets (***Re London School of Electronics Ltd*** **[1986]**).

Remedies

Where a **s 994** petition is successful, the court has considerable remedial flexibility in that it can make 'such order as it thinks fit for giving relief in respect of the matters complained of' (**CA 2006, s 996(1)**). **Section 996(2)** provides a non-exhaustive list of examples of orders that the court could make, including:

- an order regulating the conduct of the company's affairs in the future (e.g. depriving a director of certain powers (***Re HR Harmer Ltd*** **[1959]**))
- an order requiring the company to refrain from doing an act, or to perform an act that it has failed to perform
- an order requiring the company not to make any changes to its articles without the court's permission
- an order requiring the petitioner's shares to be purchased by the company or by another member.

In practice, the final remedy (known as a share purchase order) is by far the most common remedy, under which the courts will usually order that the majority shareholders purchase the petitioner's shares.

(p. 153) A **s 994** petition is not subject to a limitation period but, as the granting of relief under **s 994** is discretionary, the court may refuse to grant a remedy where a significant period of time has elapsed between the conduct complained of and the petition being brought (e.g. see ***Re Grandactual Ltd*** **[2005]** where a nine-year delay was enough to persuade the court to refuse a remedy).

Looking for extra marks?

The lack of a limitation period has been criticized on the ground that it encourages counsel to trawl through the company's history and adduce excessive amounts of evidence. As a result, **s 994** claims have gained a reputation for being overly lengthy and expensive. In an essay discussing **s 994**, these weaknesses should be noted and backed up with authority. In ***Re Elgindata Ltd (No 1)*** **[1991]**, the dispute concerned shares worth £24,600, yet the legal costs of the case exceeded £320,000. The case of ***Re Freudiana Music Co Ltd*** **[1995]** took over 165 days of court time, with the successful respondent awarded costs of £2 million.

The petition for winding up

Perhaps the most extreme remedy available to an aggrieved member is to petition the court for an order winding up the company. Such a remedy is not available under **s 996**, but is available under **s 122(1) of the IA 1986**, which lists eight circumstances in which a winding up may be ordered. For our purposes, the two principal circumstances are:

1. A company can be wound up where the company passes a special resolution resolving that the company should be wound up (**IA 1986, s 122(1)(a)**). However, this remedy will be of little use to a minority shareholder.
2. The key provision is found in **s 122(1)(g)**, which allows the court to wind up a company where it is of the opinion that it is just and equitable to do so. A single member can petition the court under **s 122(1)(g)**, so potentially it is an extremely significant remedy.

Revision tip

A member may have multiple potential remedies. Problem questions may require you to discuss the unfair prejudice remedy and the petition for winding up, so you should ensure you are aware of the relationship between the two remedies. It is common for members to seek a remedy under both **s 994 of the CA 2006** and **s 122(1)(g) of the IA 1986**, although a Practice Direction exists stating that petitioners should not apply under **s 994 and s 122(1)(g)**, unless a winding up is genuinely preferred. **Section 125(2) of the IA 1986** provides that the court will not order a winding up where an alternative remedy is available and the petitioner is acting unreasonably in seeking winding up. This indicates that the remedies are complementary, but winding up will only be rarely ordered.

(p. 154) When will a court order a winding up?

The words 'just and equitable' are broad terms and the courts have not sought to exhaustively define when a winding up will be ordered. Despite this, certain instances can be identified where courts are more likely to order a winding up:

- where the company is fraudulently promoted (***Re London and County Coal Co*** **(1866)**) or is set up for a fraudulent purpose (***Re Walter Jacob Ltd*** **[1989]**)
- where the company is deadlocked (i.e. where management or the members are divided and refuse to be

reconciled) and is unable to make any decisions (***Re Yenidje Tobacco Co Ltd* [1916]**)

- where the company's objects clause indicates that it has been formed for a specific purpose (this is known as the company's 'substratum'), and it becomes impossible to fulfil this purpose (*Re German Date Coffee Co* (1882)). With the introduction of default unrestricted objects, cases involving loss of substratum will lessen significantly over time
- where the directors display a lack of probity (i.e. honesty or decency) (***Loch v John Blackwood Ltd* [1924]**). Note that mere negligence or inefficiency will not suffice.

Quasi-partnerships

Section 122(1)(g) of the IA 1986 (along with other member remedies) acquires an increased importance where the company in question is a 'quasi-partnership'. What constitutes a quasi-partnership and the importance of **s 122(1)(g)** to such companies was the subject of the following case.

Ebrahimi v Westbourne Galleries Ltd [1973] AC 360 (HL)

FACTS:

In 1945, E and N formed a partnership. In 1958, they incorporated the business and E and N became the company's directors. Shortly thereafter, G (N's son) also became a director. Between them, N and G held the majority of the company's shares. In 1969, a dispute arose and N and G used their shares to vote E out of office. E petitioned the court for a winding-up order.

HELD:

In many companies, the rights of the members will be exhaustively stated in the company's constitution. However, quasi-partnerships will conduct business based on legitimate expectations and agreements made between the members and, in such companies, effect should be given to these expectations and agreement. Although the requirements that make a quasi-partnership cannot be exhaustively stated, typically quasi-partnerships will display all, or some, of the following characteristics:

- the company will be formed based on mutual trust and confidence
- there will be an agreement that some, or all, of the members will be involved in management
- (p. 155) the shares will not be freely marketable, meaning that an aggrieved shareholder may be locked into the company.

The company in ***Ebrahimi*** was clearly a quasi-partnership and was formed on the basis that the shareholders would be involved in management. As this understanding was breached, the House ordered the company to be wound up.

The majority of cases involving **s 122(1)(g)** involve members of quasi-partnerships who have been excluded from management.

Looking for extra marks?

For a discussion of the importance of **s 122(1)(g)** in relation to quasi-partnerships, see MR Chesterman, 'The "Just and Equitable" Winding Up of Small Private Companies' (1973) 36 MLR 129.

(p. 156)

Case	Facts	Principle
***Ebrahimi v Westbourne Galleries Ltd* [1973]** AC 360 (HL)	The three sole members of a quasi-partnership company were also its directors. Two of them used their votes to remove the third from the board.	In quasi-partnerships, the members will usually expect to be involved in management. Where this expectation is breached, the court may order the company to be wound up.
***Foss v Harbottle* (1843)** 2 Hare 461	The directors had misapplied company property, thereby causing the company loss. Two members commenced proceedings to make the directors account for the misapplied property.	The loss was sustained by the company and so only the company could sue for redress. The members cannot commence proceedings for loss sustained by a company—the company is the proper claimant.
***Gamlestaden Fastigheter AB v Baltic Partners Ltd* [2007]** UKPC 26	The directors of a company had improperly removed funds from the company. The company became insolvent. The claimant (a member and creditor of the company) argued that the directors' conduct was unfairly prejudicial.	In such cases, the claimant should not be denied a remedy, even though the remedy will benefit him principally as a creditor, and not as a member.
***Grace v Biagioli* [2005]** EWCA Civ 1222	The claimant was a member and director of a company. He was removed from office because he was attempting to set up a rival company.	The conduct complained of was prejudicial but, given the obvious conflict of interest that the claimant's actions had created, it was not unfair.
***Mission Capital plc v Sinclair* [2008]** EWHC 1339 (Ch)	The defendant directors' employment was terminated. The defendants sought permission to continue a derivative claim.	Permission will likely be refused where a notional director would not seek to continue the claim, or where the derivative claimant has a personal claim.
***O'Neill v Phillips* [1999]** 1 WLR 1092 (HL)	The defendant retired from the board and the claimant acted as *de facto* managing director. The defendant also increased the claimant's share of the profits. The defendant later reassumed control of the company and reduced the claimant's share of the profits.	In quasi-partnership companies, the courts will apply equitable considerations to give effect to informal agreements between the parties. However, in this case, the agreement was not to last indefinitely, but only so long as the claimant remained managing director.
***Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982]** Ch	The directors had engaged in a transaction at an undervalue and had misled the members. The members brought a personal action.	Where the loss sustained by the members is reflective of the company's loss, then the company is the proper claimant and the members will not be permitted to recover the reflective loss.

204 (CA)		
***Re Ghyll Beck Driving Range Ltd* [1993]** BCLC 1126 (Ch)	The claimant and three others were members and directors of a quasi-partnership company. Following an argument, the claimant was excluded from management by the others.	Where a member legitimately expects to be involved in management (as in a quasi-partnership company), then his exclusion from management can amount to unfairly prejudicial conduct.
***Re John Reid & Sons (Strucsteel) Ltd* [2003]** EWHC 2329 (Ch)	An employee of the company, who was also a member, was dismissed. He alleged that his dismissal was unfairly prejudicial.	His claim was dismissed as he was bringing his claim in his capacity as an employee, and not in his capacity as a member.
***Re Macro (Ipswich) Ltd* [1994]** BCC 781 (Ch)	The directors of a company had engaged in significant and serious acts of mismanagement.	Whilst mismanagement will not normally amount to unfairly prejudicial conduct, mismanagement that is sufficiently serious can amount to unfairly prejudicial conduct.

(p. 157) Key debates

Topic	**The derivative claim**
Author/Academic	Andrew Keay and Joan Loughrey
Viewpoint	Discusses in detail the statutory derivative claim, especially focusing on the criteria the court must consider when deciding whether or not to permit the claim to continue.
Source	‘Something Old, Something New, Something Borrowed: An Analysis of the New Derivative Action Under the Companies Act 2006’ (2008) 124 LQR 469.
Topic	**The unfair prejudice remedy and the derivative claim**
Author/Academic	Jennifer Payne
Viewpoint	Discusses the relationship between the unfair prejudice remedy and the derivative claim and argues that the two remedies should be merged.
Source	‘Section 459–461 Companies Act 1985 in Flux: The Future of Shareholder Protection’ (2005) 64 CLJ 647.

Exam questions

Essay question

> 'The statutory derivative claim provides a much more useful remedy than the common law derivative action.'

Discuss the validity of this statement.

See the Outline answers section in the end matter for help with this question.

Problem question

Helen, Tom, and Joseph have, for 10 years, run a small, but successful partnership. They decide to incorporate the business and a new company (JME Ltd) is created and the business is transferred to the new company. Helen, Tom, and Joseph become directors and each take 300 shares in the company. A further 200 shares are issued and allotted to Dave, a local businessman. The articles of JME Ltd provide that (i) no director can be removed without his or her prior consent, (ii) each director is to receive a salary of £150,000 per year, and (iii) any shareholder who wishes to sell his shares must first offer them to the directors.

After incorporation the company was successful but no dividends were paid as all the profits were ploughed back into the company, the directors drawing only their salaries of £150,000 each year.

(p. 158) In 2013 Joseph had an argument with Tom and Helen over matters of business policy. After this argument, Tom and Helen made all the business decisions in advance and outvoted Joseph at all the directors' meetings. Joseph initially complained but has now lost interest and ceased attending meetings.

Recently, Tom and Helen have voted to remove Joseph as a director at a general meeting and also have voted to distribute the profits by increasing the directors' salaries to £300,000 per annum.

Discuss whether or not JME Ltd has been run in a manner that is unfairly prejudicial, or whether any conduct has taken place that would justify winding up the company.

Online Resource Centre

To see an outline answer to this question log onto www.oxfordtextbooks.co.uk/orc/concentrate/

Law Trove

Company Law Concentrate: Law Revision and Study Guide (3rd edn)

Lee Roach

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10. Corporate rescue and insolvency

Chapter: (p. 159) 10. Corporate rescue and insolvency
Author(s): Lee Roach
DOI: 10.1093/he/9780198703808.003.0437

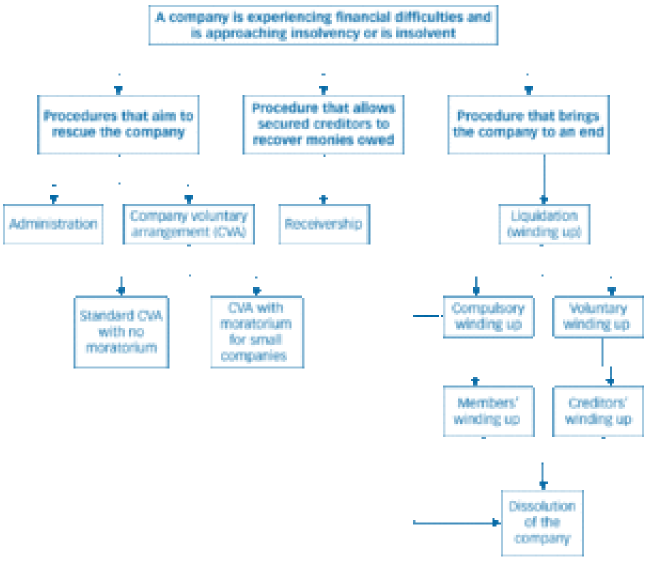
Key facts

- The Insolvency Act 1986 aims to establish a rescue culture by creating mechanisms designed to help companies that are experiencing financial difficulties.
- The most pro-rescue mechanism is administration, the principal aim of which is to rescue the company as a going concern.
- A company and its creditors can enter into a legally binding arrangement known as a company voluntary arrangement.
- The process whereby a company's assets are collected and distributed to persons entitled to them, prior to the company being dissolved, is known as liquidation (or winding up).
- There are two types of liquidation, namely a compulsory winding up and a voluntary winding up. There are two types of voluntary winding up, namely a members' voluntary winding up and a creditors' voluntary winding up.
- A liquidator is given substantial powers in relation to collecting assets of the company, increasing the pool of assets available for distribution, and invalidating or obtaining redress for certain transactions and

agreements.

• Upon liquidation, the liquidator of a company must distribute its assets to entitled persons in a specified order.

(p. 160) Chapter overview



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(p. 161) Introduction

This final chapter discusses the various procedures available to companies that are experiencing financial difficulties that are so severe that the company's survival is in jeopardy. A company need not utilize any of these procedures and may simply try to trade its way out of difficulty but, in many cases, such a strategy will not succeed and the company will need the law's aid in order to survive. Conversely, the company might decide, or be forced to conclude, that there is no prospect of avoiding insolvency and may begin the process to end its existence. This chapter discusses the various procedures that:

• aim to help struggling companies

• help creditors recover monies owed, and

• commence the process of ending the company existence and provide for the distribution of its remaining assets.

Revision tip

Not all company law courses discuss the various insolvency procedures. If your course does not discuss insolvency law, then much of this chapter may not be relevant. Note, however, that some areas of insolvency law (e.g. the provisions relating to wrongful trading) are relevant to other areas of company law that your course may cover.

Fostering a 'rescue culture'

The failure of a company and its subsequent liquidation can have a substantial adverse effect on a significant number of persons. The company's employees will lose their jobs. The company's creditors are unlikely to recover in full, if at all, the debt owed to them. The shares of the company will become worthless, thereby causing the members to lose the value of their investment. The company's suppliers and retailers will likely suffer. If the company is large enough, its liquidation may even adversely affect the economy of the country in which it is based.

Given these consequences, one would assume that the law would be keen to help struggling companies, but prior to the **Insolvency Acts of 1985 and 1986**, the law offered little aid and struggling companies had to fend for themselves. The Cork Report of 1982 strongly favoured establishing a 'rescue culture' under which mechanisms would be created that aided financially struggling companies. The **Insolvency Act 1986 (IA 1986)** provides for a number of mechanisms that aim to rescue struggling companies in order to bring them back to profitability, or to achieve a more advantageous winding up. A number of such mechanisms exist, with perhaps the most useful being administration.

(p. 162) Looking for extra marks?

A possible essay question might require you to discuss whether the law should aid struggling companies or whether they should be simply left to die. For the discussion of the merits of a rescue culture, see Muir Hunter, 'The Nature and Functions of a Rescue Culture' [1999] JBL 491 and Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (2nd edn, CUP 2009) ch 6.

Administration

In January 2009, the UK entered recession with the preceding months notable for the number of high street companies (e.g. Woolworths, Zavvi, USC, MFI) that went into administration. Even once the recession was over, the sustaining difficult economic conditions resulted in many more high street companies entering administration (e.g. HMV, Blockbuster, Comet, JJB Sports, Peacocks). In such difficult economic times, the value of pro-rescue procedures is greater than ever, with perhaps the most pro-rescue procedure being administration. The pro-rescue nature of administration is evident in the hierarchy of objectives that an administrator is appointed to achieve, as set out by **Sch B1, para 3 of the IA 1986**, illustrated by Figure **10.1**.

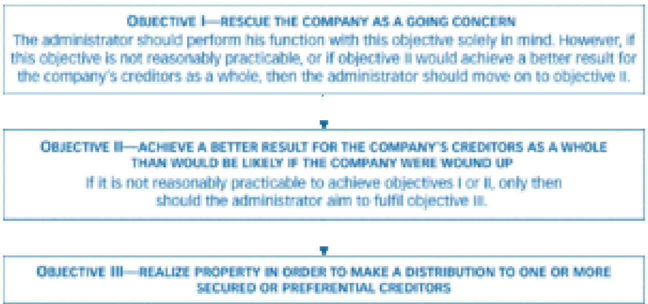

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Figure 10.1
The purposes of administration

Looking for extra marks?

Be aware of the advantages that administration can have over liquidation including:

- administration is usually cheaper than liquidation

- administration may allow the business of the company to be sold as a going concern, rather than as a 'fire sale' on liquidation, under which the assets are sold off for whatever price the liquidator can obtain
- the creditors (and directors and employees) may have better prospects of being paid than they would if the company was liquidated.

When a company enters administration, an administrator will be appointed who will from then on manage the company's affairs, with **Sch 1 of the IA 1986** providing administrators with substantial powers to achieve the hierarchy of objectives. The directors can no longer exercise any managerial powers without the administrator's consent. The objectives of administration would be frustrated if the company's creditors could enforce their security and remove assets from the company. Accordingly, the most important and beneficial aspect of administration is the statutory moratorium, which provides that, during the period of administration, unless permission has been obtained from the administrator or the court, no creditor can enforce their security over the company's property, or institute or continue legal proceedings against the company or property of the company (**IA 1986, Sch B1, para 43**).

Looking for extra marks?

For a detailed evaluation of administration as a rescue procedure, see Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (2nd edn, CUP 2009) 392–451.

(p. 163) Company voluntary arrangements

The company voluntary arrangement (CVA) is an important, but much underused, rescue procedure that basically allows the company to enter into a binding arrangement with its creditors. A CVA involves a number of stages:

1. A proposal for an arrangement must be made that will form the basis of the CVA. If the company is in administration, the administrator will make the proposal. If it is in liquidation, the liquidator will make the proposal. In all other cases, the directors will make the proposal. Note that creditors and members cannot create and submit a proposal.
2. If approved, the arrangement will need to be supervised. If an administrator or liquidator made the proposal, he can supervise the arrangement. If the directors made the proposal, a nominee will need to be appointed to supervise the arrangement.
3. The administrator/liquidator/nominee must submit a report stating whether the proposed CVA has a reasonable prospect of being approved and implemented and whether or not meetings of the company and its creditors should be convened to consider the proposal.
4. If the administrator/liquidator/nominee recommends that such meetings be called, they should be called in order to approve the proposal. In the event of the meetings reaching conflicting decisions, the decision of the creditors' meeting will prevail.
5. If the proposal is approved, it will bind the company and will be supervised by the administrator/liquidator/nominee.

(p. 164) Unlike administration, a CVA does not normally provide for a statutory moratorium. However, a moratorium will be provided where the company is a small company, with **s 382 of the CA 2006** stating that a small company is a company that satisfies at least two of the following three criteria:

1. a turnover of no more than £6.5 million
2. a balance sheet total of no more than £3.26 million
3. employees numbering no more than 50.

It should be noted that this definition of a small company applies to many provisions within the **CA 2006** and **IA 1986**, and not just to CVAs.

Looking for extra marks?

In 2013, 2,365 companies went into administration, compared to just 577 companies that entered into a CVA. Be aware of why administration is more popular than the CVA, namely because all administrations come with a moratorium and the procedures for entering administration are considerably less cumbersome and complex than the procedures relating to proposing and approving a CVA. However, from the point of view of the directors, a CVA may be preferable as it will allow them to remain in control of the company.

Receivership

Receivership is a mechanism by which a secured creditor can recover money owed by a company. Receivership usually occurs when a secured creditor appoints a receiver, who then takes control of the charged assets and uses them to satisfy the debt of the creditor who appointed him. In many cases, the instrument creating the security will grant the creditor the power to appoint a receiver without the need to apply to the court. Where such a power does not exist, the creditor will need to apply to the court for an order appointing a receiver.

Unless appointed by the court, the receiver's principal duty is to the creditor who appointed him, and he is free to subordinate the interests of the company or other creditors to those of his client.

Liquidation

In many cases, corporate rescue is not possible and a company that cannot trade out of difficulty will be liquidated (also known as 'winding up'). Liquidation is the final step before a company's dissolution and is the process whereby the assets of the company are collected and realized, its debts and liabilities paid, and the surplus distributed to the members. Liquidations come in two forms:

1. compulsory, and
2. voluntary.

(p. 165) Compulsory winding up

A compulsory winding up occurs where a specified party petitions the court to have a company wound up on specific grounds. The court has no power to compulsorily wind up a company on its own initiative: a compulsory winding-up order can only be made following a petition from a specified person, with **s 124 of the IA 1986** providing that persons who can petition the court include:

- the company itself
- the directors of the company
- any creditor of the company
- an administrator or official receiver
- a contributory of the company (this would include members of the company).

The court will only consider a petition from these parties on specific grounds, which can be found in **s 122(1) of the IA 1986**. Specified grounds include:

- where the company has, by special resolution, agreed that the company should be wound up
- where the company is unable to pay its debts
- where the court is of the opinion that it is just and equitable that the company should be wound up (discussed at p 153, 'The petition for winding up').

The vast majority of compulsory winding-up orders are made on the ground that the company is unable to pay its

debts and, of orders sought under this ground, the vast majority of the petitions are made by a creditor (usually the creditor whose loan the company has failed to repay).

Voluntary winding up

Voluntary liquidations significantly outnumber compulsory liquidations (of the 22,715 liquidations that took place in 2012–13, 16,848 were voluntary). A company can be voluntarily wound up in one of two ways:

1. a members' voluntary winding up, or
2. a creditors' voluntary winding up.

In both cases, the winding up is commenced by the members passing a special resolution agreeing that the company is to be wound up voluntarily (**IA 1986, s 84(1)(b)**). The distinction between a members' and a creditors' voluntary winding up depends on whether a declaration of solvency is made. A declaration of solvency is a declaration by the majority of the directors which states that the directors have made a full enquiry into the company's affairs and have formed the opinion that the company will be able to pay its debts in full within a period, **(p. 166)** not exceeding 12 months from the commencement of the winding up, as may be specified in the declaration (**IA 1986, s 89(1)**).

Where such a declaration is made, the winding up will be a members' winding up and the creditors will likely be paid in full. Where no declaration is made, the winding up will be a creditors' winding up and the creditors may not be paid in full. Different procedures govern the two forms of voluntary winding up.

The role and powers of a liquidator

Irrespective of the type of winding up, a liquidator will be appointed to oversee the company's liquidation. The liquidator occupies an extremely important position and his role is basically to gather in all the assets of the company, to pay off its debts and liabilities, and to distribute the remaining assets to persons entitled to them in the correct order.

> Revision tip
>
> Problem questions requiring you to advise a liquidator in the carrying out of his functions are popular in exams. Ensure that you are aware of the role of the liquidator and the powers given to him to aid him in carrying out his various functions.

To enable the liquidator to carry out his various functions, **Sch 4 of the IA 1986** grants liquidators an extremely wide array of powers, including:

- the ability to pay any creditors in full
- the power to bring or defend legal proceedings on behalf of the company
- the power to carry on the running of the business in order to achieve a more beneficial winding up
- the power to sell any of the company's property.

In addition to these powers, the liquidator can maximize the size of the pool of assets by requiring certain persons to make contributions, by preventing assets from being removed and by invalidating certain transactions or agreements. In the case of the summary remedy against delinquent directors, etc. the liquidator himself may be required to make a contribution.

> Revision tip

In problem questions concerning liquidation, the liquidator's powers to obtain a contribution, prevent assets being removed, or set aside certain transactions or agreements arise frequently. Make sure you are aware of the operation of these powers.

Misfeasance

Section 212 of the IA 1986 applies where, during the course of a liquidation, it appears that an officer of the company, a liquidator, an administrative receiver, or other person involved (p. 167) in the promotion, formation, or management of the company has misapplied or retained, or become accountable for, any money or other property of the company, or has been guilty of any misfeasance or breach of any fiduciary or other duty in relation to the company. Misfeasance refers to the improper or unlawful performance of a lawful act.

Where **s 212** has been breached, the court can order the defendant to contribute to the pool of assets for distribution by the liquidator, or to repay, restore or account for any money or property that was misapplied or retained.

Fraudulent trading

Section 213 of the IA 1986 provides that if, in the course of a winding up of a company, it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, then the court, on the application of the liquidator, may declare that any persons (not just the directors) who were knowingly parties to the carrying on of the business in such a way are liable to make such a contribution to the company's assets as the court thinks proper. Where a director has engaged in fraudulent trading, the court can also disqualify the director for up to 15 years (**Company Directors Disqualification Act 1986, s 10**).

(p. 168) Revision tip

Fraudulent trading under **s 213** should not be confused with the criminal offence of fraudulent trading under **s 993 of the CA 2006. Section 213** only applies during a winding up and imposes civil liability only. **Section 993** can apply at any time and imposes criminal liability only. However, it is possible for one fraudulent transaction to breach both provisions and civil and criminal liability to be imposed.

Wrongful trading

As fraud must be proved beyond reasonable doubt and the liquidator must prove subjective knowledge of the fraud, successful actions under **s 213** are rare. The Jenkins Committee (1962) and the Cork Committee (1982) therefore recommended that a lesser form of civil liability be introduced and this was implemented by **s 214 of the IA 1986. Section 214** allows the court to require directors to make a contribution to the assets of the company where they have engaged in 'wrongful trading', namely that, during the course of a winding up, it appears that:

- the company has gone into insolvent liquidation, and
- at some point before the commencement of the winding up of the company, that person knew, or ought to have concluded, that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and
- that person was a director of the company at the time.

Revision tip

In problem questions, wrongful trading is often difficult to identify. Where the facts of a problem include (i) a

recommendation (usually from an auditor) or opinion that insolvency is unlikely to be avoided, or (ii) a director states that he believes the company should be wound up, or (iii) the company suffers financial losses (e.g. poor trading prospects, increasing overdraft etc.), but continues to trade, this is providing a strong hint that you should discuss whether or not the directors have engaged in wrongful trading.

The first reported case concerning **s 214** provides an example of the operation of wrongful trading in practice.

Re Produce Marketing Consortium Ltd [1989] BCLC 520 (Ch)

FACTS:

A fruit-importing company was incorporated in 1964 and was profitable until 1980. Between 1980 and the company's liquidation in October 1987, its profitability and turnover decreased, it built up a large overdraft and its liabilities exceeded its assets. By February 1987, one of the company's two directors was of the opinion that insolvency was inevitable, but the company continued to trade until October 1987, in order to dispose of fruit that had been in cold storage. The company's liquidator sought a contribution from the two directors under **s 214**.

HELD:

The two directors should have realized by July 1986 that liquidation was inevitable. Liquidation at this time would have saved the company £75,000 and so the two directors were ordered to contribute this amount to the company's assets.

On several occasions, the courts have stressed that trading whilst insolvent does not, in itself, constitute wrongful trading and the directors may properly conclude that continuing to trade whilst insolvent is the correct course of action (e.g. Chadwick J in ***Secretary of State for Industry v Taylor* [1997]**), as the following case demonstrates.

Re Hawkes Hill Publishing Co Ltd [2007] BCC 937 (Ch)

FACTS:

The company published a free magazine whose profitability was dependent upon revenue generated through advertising. The company had exhausted all of its loan capital, experienced significant cash-flow problems and was trading at a loss. The directors believed that there were investors willing to invest in the company and extra revenue could be generated by raising the amount and the cost of advertising space, so the company continued to trade. Their belief proved incorrect and, soon thereafter, the company went into liquidation. The liquidator alleged that the directors had engaged in wrongful trading.

HELD:

Wrongful trading does not occur simply because a company continues to trade at a time when the directors knew, or ought to have known, that the company was insolvent or could not pay its debts. Liability will only be imposed where a company continues to trade at a time when the directors knew, or ought to have known, that there was no reasonable prospect of avoiding **(p. 169)** insolvent liquidation. Here, the directors did not know this—they reasonably believed that the company could trade its way out of difficulty and return to solvency. Accordingly, the directors had not engaged in wrongful trading.

Finally, it should be noted that liability will not be imposed if, after the person realized that there was no reasonable prospect of avoiding insolvent liquidation, he took every step that he ought to have taken to minimize the potential

loss to the company's creditors (**IA 1986, s 214(3)**).

Transactions at an undervalue

The directors of a struggling company may sell off the company's assets cheaply (usually to the directors themselves or other connected persons) in order to place them out of the control of a future liquidator or administrator. To combat this, **s 238 of the IA 1986** provides that where, at the relevant time, a company has gone into liquidation (or administration), the liquidator (or administrator) may apply to the court for a remedy on the ground that the company has entered into a transaction at an undervalue. If the application is successful, the court will make such an order as it thinks fit for restoring the company to the position it would have been in had the company not entered into the transaction (**IA 1986, s 238(3)**).

Section 238 only applies where the transaction was entered into at the 'relevant time', with the relevant time being two years ending on the date of insolvency (**IA 1986, s 240(1)(a)**). However, the transaction will only fall within the relevant time if, at the time the transaction was made, the company was unable to pay its debts, or became unable to pay its debts due to the transaction (**IA 1986, s 240(2)**).

Preferences

Upon liquidation, the liquidator will pay off the company's creditors, with differing types of creditor ranking more highly than others, who will accordingly be paid first (this hierarchy is discussed at p 170, 'Distribution of assets'). A company may attempt to avoid this hierarchy by paying off certain low-ranking creditors prior to liquidation (especially if the creditor is connected to the company or directors), with the result that, upon liquidation, there may not be enough assets to pay the higher-ranking creditors. This is known as a 'preference' and where the company has provided a creditor with a preference, **s 239 of the IA 1986** allows the liquidator to apply to the court, which can make such an order as it thinks fit for restoring the company to the position in which it would have been had the company not given the preference.

Like transactions at an undervalue, the preference must be made at the 'relevant time' in order to attract a remedy. What constitutes the relevant time will depend upon the identity of the person to whom the alleged preference was granted:

- If the company granted the alleged preference to someone connected with the company (e.g. directors, or wives, husbands, business partners, or employees of connected persons), then the relevant time is two years ending on the date of insolvency.
- In all other cases, the period is six months, ending on the date of insolvency.

(p. 170) In addition, the preference will only fall within the relevant time if, at the time the preference was made, the company was unable to pay its debts, or became unable to pay its debts due to the preference (**IA 1986, s 240(2)**).

Extortionate credit transactions

Section 244 of the IA 1986 allows a liquidator (or administrator) to petition the court for a remedy where, within a three-year period ending on the date of insolvency (or the granting of the administration order), the company entered into an 'extortionate credit transaction'. Unless the contrary is proven, a credit transaction will be presumed to be extortionate if it requires grossly exorbitant payments to be made or if it grossly contravenes ordinary principles of fair dealing.

Where **s 244** has been breached, the court has extremely strong remedial powers, including the ability to completely set aside the transaction, or to vary the terms of the transaction.

Avoidance of floating charges

The directors of a company may cause the company to grant them (or another person) a floating charge over the assets of the company, thereby prioritizing themselves over unsecured creditors in the event of the company's liquidation. To prevent this, **s 245 of the IA 1986** invalidates floating charges created within the relevant time prior to

insolvency, with the relevant time being:

- two years where the charge was granted to a person connected with the company, or
- 12 months where the charge was granted to an unconnected person.

Distribution of assets

Once the liquidator has collected and realized the assets of the company (including seeking contributions from persons who have breached the provisions just mentioned), he will then need to use these assets to meet the company's debts and liabilities.

> Revision tip
>
> Where a problem question has you advising a liquidator, you will almost certainly be required to advise the liquidator as to how the assets of the liquidated company should be distributed. Alternatively, you may be advising a creditor on his chances of recovering fully the amount loaned to the company. Either way, the rules relating to the distribution of assets upon liquidation are of crucial importance.

The distribution of assets is generally subject to the *pari passu* rule (*pari passu* means 'with equal step'), which means that creditors receive an equal share of the company's assets. However, as we shall see, the *pari passu* rule is subject to several exceptions, with the first relating to creditors who secure their loans via a charge.

(p. 171) Chargeholders

Where a person has secured a debt by way of fixed charge (discussed at p 131, 'Fixed charges'), then, upon the company's liquidation, he can simply take the charged assets, sell them and use the proceeds to satisfy the debt owed to him. Accordingly, a fixed chargeholder does not need to rely upon the liquidator to obtain satisfaction of his debt.

Regarding floating charges (discussed at p 131, 'Floating charges'), the position is more complex. Floating charges created after 15 September 2003 are subject to new rules created by the **Enterprise Act 2002**. Regarding such charges, once the liquidator has determined the assets that would go to floating chargeholders, he must set aside a percentage of those assets to pay off the unsecured creditors. The percentage is:

- 50 per cent of the first £10,000
- 20 per cent of the remainder, up to a limit of £600,000.

Liquidation expenses and post-liquidation debts

The first debt that the liquidator will pay off will be the expenses incurred in the liquidation process. Liquidation expenses rank ahead of all other claims (**IA 1986, ss 115, 156 and 176ZA**), except those of fixed chargeholders, who need not rely on the liquidator to obtain satisfaction of the debt.

During the course of the liquidation process, the liquidator might determine that a more advantageous winding up can be achieved if the company were to continue to trade for a time. The company will most likely be unable to obtain any share capital for obvious reasons, so the company may need to obtain debt capital in order to continue trading. Creditors would be unwilling to provide the company with capital if they did not obtain priority upon the inevitable liquidation. Accordingly, post-liquidation debts are regarded as liquidation expenses (**Insolvency Rules 1986, r 12.2**) and so have priority over other debts, except those of fixed chargeholders.

Preferential debts

Statute classifies certain debts as preferential debts, meaning that they rank ahead of most other debts (except debts secured by fixed charge and liquidation expenses). The categories of preferential debts can be found in **Sch 6 of the IA 1986**, but it is worth noting that Crown debts (e.g. debts owed to HM Revenue & Customs) are, following the **Enterprise Act 2002**, no longer classified as preferential, with the Insolvency Service estimating that this will result in around £70 million per year being paid to other creditors. Current preferential debts include:

- pension scheme contributions
- remuneration owed to employees (but only sums up to £800 will rank as preferential—the remainder will rank as unsecured)
- any amount owed by way of accrued holiday pay.

(p. 172) Preferential debts rank equally amongst themselves, meaning that if there are insufficient assets to pay fully all of the preferential creditors, then the preferential creditors will receive an equal proportion (**IA 1986, s 175(2)**). This will, of course, mean that creditors who rank below the preferential creditors will receive nothing.

The order of distribution

The order in which a liquidator must distribute the assets is as shown in Figure **10.2**.

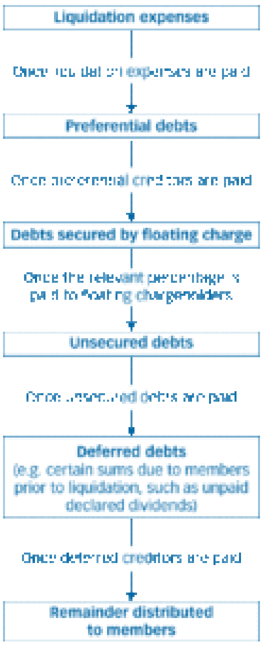

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Figure 10.2
The distribution of assets

The groups are paid off one by one, meaning that once a group is paid in full, the remaining assets are used to pay the next group. If there are insufficient assets to pay a group fully, each creditor amongst that group will receive the same percentage of their debt (i.e. the *pari passu* rule applies amongst members of each group). Of course, lower ranking creditors will **(p. 173)** then go unpaid. Therefore, the higher the creditor ranks, the more likely the creditor will be paid in part or in full.

Key cases

Case	Facts	Principle
***Re Hawkes Hill Publishing Co Ltd* [2007]** BCC 937 (Ch)	A company continued to trade even though it was insolvent and the directors knew that the company could not pay its debts.	Trading whilst insolvent is not enough, in itself, to establish liability for wrongful trading. Liability will only be imposed if the directors also knew, or ought to have known, that there was no reasonable prospect of avoiding insolvent liquidation.
***Re Produce Marketing Consortium Ltd* [1989]** BCLC 520 (Ch)	A company, which was profitable until 1980, became increasingly unprofitable until its liquidation in 1987. The directors continued to trade at a time when insolvency looked inevitable.	Prompt liquidation in July 1986, by which time the directors should have realized that insolvency was unavoidable, would have saved the company £75,000. The directors had therefore engaged in wrongful trading and were ordered to contribute £75,000 to the company's assets.

Key debates

Topic	**The rescue culture**
Author/Academic	Muir Hunter
Viewpoint	Discusses in depth what constitutes a rescue culture and whether such a culture is desirable or justified.
Source	'The Nature and Functions of a Rescue Culture' [1999] JBL 491.
Topic	**Wrongful trading**
Author/Academic	Carol Cook
Viewpoint	Discusses the effectiveness of **s 214 of the IA 1986** and examines a number of cases concerning the provision. Argues that **s 214** has yet to reach its full potential.
Source	'Wrongful Trading: Is It a Real Threat to Directors or Is It a Paper Tiger?' (1999) Insolv L 99.

 ## Exam questions

Essay question

To what extent has the UK adopted a rescue culture and should the law aid struggling companies?

See the Outline answers section in the end matter for help with this question.

Problem question

In March 2010, Emily and Becky incorporated a company (Shoes in the City Ltd) that specialized in selling ladies' footwear. Emily and Becky were the company's only members and each owned 100 £1 shares. Emily and Becky were the company's only directors.

The company began to experience financial difficulties. In September 2013, the company's overdraft with the Black Horse Bank plc had reached its limit of £250,000. In return for increasing the overdraft limit to £300,000, the Black Horse Bank plc demanded security and took a floating charge over all the company's assets. The business continued to struggle and, in January 2014, Emily and Becky were informed by the company's auditor that insolvent liquidation was inevitable, although Emily and Becky disagreed and held out hope that the company's financial prospects would improve. Emily and Becky decided to try and trade their way out of their financial difficulties by having a sale. Unfortunately, the sale failed to increase business and in March 2014, Shoes in the City was wound up. By this time, the company's overdraft with Black Horse Bank amounted to £290,000.

Barry has been appointed liquidator and has discovered several disturbing facts: (i) in August 2013, Emily and Becky caused the company to repay an unsecured loan of £5,000, which Becky had made to the company some months before; (ii) in addition to the money owed to Black Horse Bank, the company owes £10,000 to the Inland Revenue, £30,000 to employees in wages, and £100,000 to unsecured creditors.

Barry estimates that the total remaining assets of Shoes in the City amount to £150,000. Barry's expenses in acting as liquidator amount to £3,000. Advise Barry.

Online Resource Centre

To see an outline answer to this question log on to www.oxfordtextbooks.co.uk/orc/concentrate/

Law Trove

Company Law Concentrate: Law Revision and Study Guide (3rd edn)

Lee Roach

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Print ISBN-13: 9780198703808
DOI: 10.1093/he/9780198703808.001.0001
Print Publication Date: Jul 2014
Published online: Sep 2014

Exam essentials

(p. a1) Exam essentials

Identify the topic(s)

In any exam, one of the most crucial skills is the ability to correctly identify the legal topic(s) involved. Often, exam questions (especially problem questions) will not expressly identify the legal topic involved, so you will have to identify the topic and, if you misidentify the topic, you will lose the majority, if not all, of your marks. Identifying the correct topic(s) in company law problem questions can be a challenge because, as is discussed in the next section, company law topics can often impact upon one another.

Be aware of how topics can overlap

Students tend to assume that each exam question will cover a single topic, but this is often not the case. Company law topics do not exist in isolation from each other and it is perfectly possible that an exam question (especially a problem question) could cover multiple topics. For example, a problem question involving a director who engages in acts that are outside the scope of the company's constitution might require you to discuss (i) the *ultra vires* rules; (ii) enforcing the statutory contract; (iii) whether or not the director had breached the duty found in **s 171 of the CA 2006**; and (iv) whether or not a derivative claim can be brought. You should be aware of how topics could possibly overlap and throughout this text, potential overlaps have been highlighted.

Companies Act 2006 reforms

Although the **CA 2006** was passed in 2006, it has only been fully in force since 2009. Accordingly, much of the law contained in the Act is relatively new, and much of the law differs to that found in the **CA 1985** (where appropriate, this text has identified the key differences between the 1985 and 2006 Acts). Essay questions often require you to discuss the reforms found in the **CA 2006**, so it pays to be aware of how the 2006 Act differs to its 1985 predecessor, and how the 2006 Act has been amended since its enactment. The consultation process for the 2006 Act was lengthy, so there is a substantial body of academic literature that discusses the changes introduced by the 2006 Act. Be prepared to discuss to what extent, if any, the 2006 Act has improved the law in key areas, or how the 2006 Act has (or has not) been improved by subsequent amendments.

Avoid focusing exclusively on the CA 2006

Although the **CA 2006** is central to our company law system, students tend to focus on it exclusively, and tend to ignore other rules and recommendations that are of equal importance. In particular, do not ignore:

(p. a2) • *The constitution of the company*: The **CA 2006** is silent in relation to many areas of corporate activity (especially concerning the internal activities of companies), preferring to leave such issues to be determined by the companies themselves via the company's constitution. The articles form the principal constitutional document and can, in some cases, modify or disapply provisions found in the **CA 2006**. In many problem questions, the content of the articles is not stated, and so it is safe to assume that the model articles are used. Accordingly, it is wise to have a sound knowledge of the provisions of the model articles and how such articles differ to prior model articles found under previous Companies Acts.

• *Corporate governance reports and codes*: As regards certain areas of company law, the **CA 2006** is silent (e.g. non-executive directors, remuneration/nomination/audit committees). In such cases, the recommendations found in the relevant corporate governance reports and codes (notably the **UK Corporate Governance Code** and the **UK Stewardship Code**) are of clear importance and usually go well beyond what is required by the law. Unfortunately, many students lack sufficient knowledge of the relevant reports and codes, which is a major mistake given the importance of the sources, especially to larger companies.

• *The Listing Regime*: UK listed companies are required to adhere to a strict body of rules, namely (i) the **Listing Rules**, (ii) the **Disclosure and Transparency Rules**, and (iii) the **Prospectus Rules**.

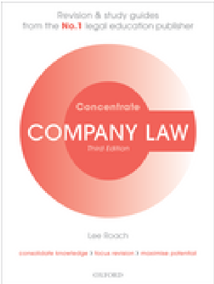
• *EU law*: EU law has had a significant impact upon the UK system of company law, as many provisions within the **CA 2006** were included, or have since been modified, in order to comply with EU legislation (usually the various EU company law directives). Certain provisions of the **CA 2006** may have been criticized, but cannot be changed as they were included to satisfy out EU membership obligations. Be aware of the influence that EU law has had, and continues to have, on our system of company law.

Stay up to date with legal developments

Company law and corporate governance are constantly evolving topics (especially corporate governance) and it is vital that you remain up to date with legal developments. Be wary when relying on aging sources and ensure that your textbooks are up to date (do not rely on old editions, and even new editions may be out of date in parts). Journal articles are excellent sources of academic criticism and authority, but always double check the information found in older articles to see if it is still correct.

Staying up to date with legal developments can be onerous. Fortunately, this book is accompanied by a Twitter account (**@UKCompanyLaw**), which will do much of the work for you by providing updates of legal developments in relation to company law and corporate governance.

Law Trove



Company Law Concentrate: Law Revision and Study Guide (3rd edn)

Lee Roach

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Outline answers

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Chapter 1

Essay question

Background

• In order to answer this question, you will need to discuss the historical background to the **Limited Liability Partnerships Act 2000 (LLPA 2000)**. Understanding why the Act was passed will enable you to discuss whether the Act was designed to provide a new business vehicle for small businesses.

• It is important that you state that the lobbying for the introduction of the LLP came almost entirely from large professional firms, especially the largest accountancy firms. You will want to discuss why these firms did not believe that neither the standard partnership nor the company suited their needs.

• Before examining the LLP, you should discuss why the standard partnership and the registered company are not ideal business structures for small businesses, namely:

1. Whilst the partnership is a flexible and private business structure, the liability of the partners for the firm's debts and liabilities is joint and unlimited.

2. Whilst the company can offer its members limited liability, and the members and directors are protected by the company's corporate personality, companies are subject to a significant amount of

regulation and formality, and it has historically been argued that company law legislation is not drafted with the needs of small businesses in mind.

The limited liability partnership

• Discuss to what extent the LLP is a suitable business structure for small businesses generally. You may wish to state at the outset that there is little doubt that the LLP was not designed to meet the needs of small businesses in general, largely because the LLP is so similar to a registered company.

• Like a company, the LLP will have corporate personality and the liability of its members will be limited. Accordingly, the LLP's members will not normally be liable for its debts. This certainly remedies the principal weakness of an ordinary partnership.

• However, **s 1(5) of the LLPA 2000** states that, unless the Act provides otherwise, LLPs will be governed by company law and not partnership law. Accordingly, LLPs will be regulated, for the most part, in the same manner as companies. Therefore, the formality, regulation, and loss of privacy and flexibility that can come from conducting business through a company will also apply to the LLP.

• It is worth stating at this point that the **CA 2006** does appear to provide a more suitable regulatory regime for small businesses than the **CA 1985**, but compliance with the Act can still be costly, burdensome and can result in a loss of privacy.

• It is largely accepted that the LLP does not provide a suitable business structure for small businesses in general (as evidenced by the fact that fewer than 60,000 LLPs have been incorporated), but it is a business structure designed for those who lobbied for its creation, namely large professional firms (virtually all of whom have adopted LLP status).

• The LLP does indeed have some of the best features of a company, but it also has virtually all the drawbacks and, arguably, it lacks some of the major advantages of an ordinary partnership.

Chapter 2

Essay question

• Briefly discuss the role of promoters and point out that they may wish to enter into contracts with relevant parties before the **(p. a4)** company is fully incorporated. Point out the two contradictory views that exist, namely:

> **1.** As the company is not fully incorporated, it lacks contractual capacity and so cannot enter into contracts.
>
> **2.** As the contract is usually for the benefit of the company-to-be, should the law not regard it as valid?

• The law relating to pre-incorporation contracts aims to determine whether such contracts are valid or not. Historically, this was determined by the common law.

Common law

• Point out that, at common law, the validity of a pre-incorporation contract depended upon the intent of the parties, as revealed in the contract (***Phonogram Ltd v Lane* [1982]**)—a process which proved to be notoriously difficult and which resulted in significant confusion in the law and a perception that cases in this area could turn based on complex and technical distinctions. Provide examples of these technical distinctions, namely:

> **1.** Where the promoter signed the contract as the company's agent or on behalf of the company, then a contract would exist between the promoter and the third party (***Kelner v Baxter* (1866)**).
>
> **2.** Where the promoter signed the contract using the company's name, or merely added his own name to authenticate that of the company's, then no contract would exist (***Newborne v Sensolid (Great Britain) Ltd* [1954]**).

• Several problems existed with this approach. First, the distinction was technical, complex, and often very difficult to apply in practice. Second, if the court held that no contract existed, the innocent third party who contracted with the promoter would suffer loss. Fortunately, both of these problems have been remedied by the statutory rules.

Statute

• Point out that we were required to change the law relating to pre-incorporation contracts as a result of the **First EC Company Law Directive**, of which **Art 7** is the key provision. It is worth quoting **Art 7** as we will compare it later to the relevant provision in the **CA 2006**, namely **s 51(1)**.

• Point out that **s 51(1)** abolishes the distinction made by the common law and provides that a contract will exist. Accordingly, third parties will benefit as they will be able to hold the promoter personally liable on the contract.

• However, it can be argued that problems still exist with the statutory rules:

1. The wording of **s 51** does not make clear whether or not a promoter can sue a third party on the contract. The court in ***Braymist Ltd v Wise Finance Co Ltd*** **[2002]** held that they can, but the fact that clarification was required indicates a flaw in the drafting of **s 51**.

2. Whereas **Art 7** allows the company to adopt the contract once incorporated, **s 51(1)** does not. Accordingly, the contract will need to be novated which will likely be regarded by many promoters as an unnecessary waste of time and effort.

Chapter 3

Essay question

• Normally, you would not be required to provide the facts of a case when writing an essay. However, where the essay requires you to discuss a single case, setting out the facts of the case is often useful. Accordingly, provide a brief overview of the relevant facts of ***Salomon*** and the arguments of the parties involved.

• In order to appreciate the true significance of ***Salomon***, you will want to discuss the decisions of the three courts the case was heard in:

1. At first instance, Vaughan Williams J was not prepared to grant relief based on the liquidator's claims, but he did grant relief based on the concept that the company was an agent or nominee for Mr Salomon.

2. The Court of Appeal upheld the trial judge's decision, stating that the whole transaction was contrary to the true intent of the Companies Act, and that the company was a sham and an alias, agent, trustee, or nominee for Mr Salomon. Also the Court of Appeal was in no doubt that when Parliament stipulated seven members, it meant seven genuine and active members.

(p. a5) **3.** The House of Lords unanimously reversed this decision. It held that the company was validly formed since the Act merely required seven members holding at least one share each. The Act said nothing about them being independent or that they should take an active role in the company.

Justifications

• The decision of the House in ***Salomon*** can be applauded as well as criticized. The decision encourages individuals to set up businesses by making it less risky. This is certainly true. However, as a corollary, certain individuals will set up companies that are under-capitalized, content in the knowledge that, should the company fail, they will be protected by the company's separate personality. Accordingly, the ability to use corporate personality to shield oneself from liability may encourage the setting up of unstable businesses which will have a negative effect on the economy. This, ultimately, makes business more risky for everyone. Parliament has responded by attaching personal liability in certain circumstances.

• Some argue that the market for shares relies on the ability to shield oneself from liability. Without it,

shareholdings would be limited to a few wealthy investors who can monitor their shareholdings. Small investors would be deterred from investing by the prospect of unlimited personal liability. Further, shareholders often diversify their shareholdings across a large number of companies to minimize risk. If investors could not shield themselves from liability, diversification would increase the shareholders' risk, not decrease it.

The impact of *Salomon*

• The decision of the House of Lords in ***Salomon*** is often credited with establishing the concept of separate personality. This is not true—the concept of corporate personality was recognized long before 1897, and was a clearly intended consequence of the **Joint Stock Companies Act 1844**.

• What ***Salomon*** did was to demonstrate that the courts had not, until then, fully appreciated the consequences of separate legal personality. In upholding the separate personality of the company even where the individual's control of the company was absolute, the House of Lords established that the corporate form could be used legitimately to shield an 'owner' of the business from liability. Some academics argue that this is essential in order to encourage companies to engage in risky, but potentially profitable, activities. Others argue that it encourages the setting up of unsuitable or ill-thought-out businesses.

• Two other consequences of the decision also should be noted:

1. ***Salomon*** implicitly recognized the validity of the one-man company (that is, a company run by one person with a number of dormant, nominee members) long before company law overtly allowed one-man companies to be created. The ability to create a one-man private company was only granted in 1992, and the ability to create a one-man public company was established by the **CA 2006**.

2. ***Salomon*** established that a relationship of agency or trusteeship will not be created simply because a person holds shares in a company (even if he owns all the shares).

Chapter 4

Essay question

• Begin by briefly defining the scope of a company's constitution. State that **s 33 of the CA 2006** provides that the constitution forms a contract between the members and the company, and between the members themselves. Accordingly, breach of the constitution will amount to breach of contract, providing the innocent party with a remedy.

The statutory contract

• The statutory contract created by **s 33** is indeed an unusual one. Provide examples of how the statutory contract differs from a standard contract, such as:

1. The terms of the statutory contract can be altered against the wishes of one of the parties, even after the contract has been entered into.

2. The courts will not rectify the statutory contract, nor can it be defeated on the grounds of misrepresentation, undue influence, or duress.

(p. a6) **3.** Whereas all terms of a standard contract can form the basis of an action for breach of contract, only terms relating to membership rights will form part of the statutory contract.

Enforcing the statutory contract

• You will need to discuss how straightforward it is to enforce the statutory contract. The constitution forms a contract between the company and its members, so if the company breaches the constitution, the member can obtain a remedy. The case of ***Pender v Lushington*** **(1877)** provides a good example of this.

• However, the ability of the members to enforce the constitution is subject to an important limitation, namely that

a member can only enforce the constitution if he is acting in his capacity as a member. Only provisions relating to membership rights will form part of the statutory contract. The case of ***Beattie v E and F Beattie Ltd*** **[1938]** provides a good example of this.

• This limitation can be criticized. If the company breaches a term of the constitution that does not relate to a membership right, then that term will not form part of the statutory contract and so cannot be enforced. In effect, the company would have been permitted to ignore a provision of the constitution, without having to amend it. In practice, in such cases, the member will almost certainly be able to commence proceedings under **s 994 of the CA 2006**, which demonstrates that the unfair prejudice remedy is likely to be a preferable remedy to enforcing the statutory contract.

• In the case of quasi-partnership companies, the dividing line between directors and members is often blurred. Accordingly, in such companies constitution provisions relating to the rights of directors will also form part of the statutory contract (***Rayfield v Hands*** **[1960]**).

• Often, the members may breach the constitution, which may adversely affect other members. Accordingly, the statutory contract can also be enforced by a member against another member (as occurred in ***Rayfield v Hands*** **[1960]**), providing that the right breached is a membership right.

Chapter 5

Essay question

• Begin by pointing out that, prior to the **CA 2006**, directors' duties were found in a mass of case law and statute. As a result, the law was unclear and inaccessible and many directors had little knowledge of the duties they were subject to.

• Point out that codification was not meant to radically reform the law—this is made clear by **s 170 of the CA 2006**. Accordingly, it could be argued that codification has done little to improve the law. However, the fact that the codified duties are based on pre-2006 law does not mean that codification was an unnecessary step for two reasons:

1. Placing the duties in statute has a number of notable advantages.

2. The duties under the **CA 2006** are different in several respects to their pre-2006 common law counterparts.

Advantages and disadvantages of codification

• You will then want to discuss the advantages and disadvantages of codification. Advantages include:

1. Improved accessibility—theoretically, anyone can look to the **CA 2006** and reasonably comprehend the duties owed.

2. Successful codification could result in the law becoming more predictable and will remove the judge's discretion to develop the law in subjective and unpredictable ways.

3. The duties could be expressed in broad and general language which could be applied to a wide range of situations. This would allow the law to adapt to emerging practices.

• However, codification suffers from some noteworthy disadvantages:

1. Codification may provide a clearer and more accessible statement of duties, but it will not provide a comprehensive statement of the duties of directors. The codified duties will need to be interpreted by the judges in marginal cases where the law is not clear. In such cases, recourse to the statute will not be enough and the (p. a7) relevant case law will need to be known. Accordingly, it could be argued that accessibility will only be marginally improved.

2. A corollary of this is that the codified law may not result in a notable increase in predictability. The codified duties cannot cover every situation and Parliament cannot be expected to foresee every

situation that might arise. The judges will still need to fill in any gaps that arise.

3. It is not easy to amend codified law. Most areas of company law are dynamic and the law needs to be able to respond to new situations. To amend the statutory statement of duties, an Act of Parliament would need to be passed. Amending legislation can be a long and complex process, so codified law may be slow to adapt to changing circumstances.

Similarities and differences between the common law and statutory duties

- Students should also point out those areas where the law has remained the same and those areas where the codified duties differ. As a general rule, the duties found in the 2006 Act are the same as the common law duties, albeit with some slight alterations. **Section 178(1)** even provides that the remedies for breach of the general duties will remain the same as for breach of their common law counterparts.
- However, the 2006 Act has reformed the duties in some notable ways, with the obvious example being the duty contained in **s 172**, namely to promote the success of the company for the benefit of its members. You should discuss how the **s 172** duty differs to the previous '*bona fide* in the interests of the company' duty. It has been argued by many that the common law duty was shareholder-focused, whereas the duty contained in **s 172** is more stakeholder-friendly. This is backed up by the list of relevant factors contained in **s 172(1)**, which includes the interests of employees, the community, and the environment, as well as the likely consequences of any decision in the long-term. However, in keeping with the enlightened shareholder approach, directors must have regard to these factors, but they cannot be used to override the primary duty to promote the success of the company for the benefit of its members.

Chapter 6

Essay question

- Point out that, even though the general power to manage is vested in the directors, significant power is placed in the hands of the members.
- However, historically, there has been a perception that the rules and procedures by which general meetings are run operate in order to favour the views of the company's directors, and prevent the members from effectively exercising their decision-making powers.

The calling of meetings

- The power to call meetings is a good example of how the procedures relating to general meetings can favour the directors. **Section 302 of the CA 2006** vests the power to call a general meeting in the directors. **Section 303** grants the members the power to require the directors to call a general meeting, but the Act does not make it easy for members to exercise this power.
- The directors will only be required to call a meeting if a sufficient percentage of the members require the meeting. In the case of companies with a share capital, the request must come from members representing at least 5 per cent of the company's paid-up share capital.
- This will not be an easy requirement to meet, especially in the case of large private companies and public companies where the members may be numerous and highly dispersed. Certainly for many individual members, this will likely prove an insurmountable obstacle.

Controlling the agenda and the circulation of information

- The directors normally draw up the notices of general meetings. This is an important power because of the rule that, apart from any matters designated as ordinary business in the articles, only those matters of which notice has been given can be discussed at a meeting.

• Within the boundaries of their fiduciary duties, the directors can, at the company's expense, send out circulars explaining why the members should support their resolutions.

• The members have the power to require the company to circulate a statement of not (p. a8) more than 1,000 words in relation to a matter referred to in a proposed resolution, or any other business dealt with at the meeting (**CA 2006, s 314(1)**). However, this power only arises if a sufficient number of members require the statement to be circulated.

• If these requirements cannot be met, then the members will have to pay for the cost of sending the circulars themselves and this can be extremely expensive. Accordingly, this appears to be one area where the dice are still loaded in the management's favour. In practice, resolutions are nearly always proposed by the directors, not by the members.

General meetings in practice

• In order for general meetings to be an effective mechanism for shareholder democracy, two conditions must be satisfied:

1. the majority of the shares should be held by members who are not directors, and

2. all or most of the members should be willing to participate in general meetings.

• Unfortunately, only one or neither of these conditions are present in companies at either end of the size spectrum. As regards small owner-managed companies, the shares are held wholly or mainly by the directors. These companies are run informally without reference to company law for the main. In such companies, where the directors and members are the same people, formal general meetings serve little or no use.

• General meetings fail for a different reason in the case of large public companies. Here, there may be hundreds of thousands of members living in all parts of the UK and abroad. It is impracticable for more than a tiny minority of them to attend a general meeting and many members either do not attend or vote, or allow the directors to act as their proxy, thereby increasing the voting power of the company.

• Most commentators agree that general meetings are a key mechanism in ensuring that the directors are made accountable to the members. However, the limitations discussed are also generally accepted by commentators. It appears that there is an unspoken feeling that general meetings, as a form of governance accountability, are becoming increasingly moribund.

Chapter 7

Essay question

• Begin by pointing out that the **UK Corporate Governance Code** does indeed rely heavily on non-executive directors (NEDs) in two ways:

1. NEDs are tasked with monitoring the activities of the executive directors, as well as contributing to management.

2. The Code recommends that the audit committee, nomination committee, and remuneration committee consist of NEDs.

• There is no doubt that NEDs are the governance mechanism that is currently in favour, with the Higgs Report describing them as 'custodians of the governance process'.

• You should provide a brief definition of a NED and explain how they differ to executive directors. You should also discuss the dual role of NEDs, namely to contribute to management policy and to monitor management.

Advantages of NEDs

• Discuss the advantages that NEDs have over other corporate governance mechanisms. Monitoring at board level, theoretically, has several advantages over monitoring by the members:

1. NEDs should have better access to information than the members.
2. NEDs do not suffer from the collective action problems that affect members.
3. The NEDs have much more regular, and closer, contact with the executives than the majority of members.

Disadvantages of NEDS

• Despite the fact that NEDs have some notable strengths, many academics believe that they are outweighed by the weaknesses, including:

1. As NEDs work only part-time, they are usually not able to become fully conversant with the company's business and so end up relying on the executives for information. The executives, for obvious reasons, might be selective in terms of what information they provide to the NEDs.
2. It is often argued that the NEDs' two roles (i.e. management and monitoring) do (p. a9) not sit easily with one another, and could result in a segregated board.
3. NEDs can only be effective if they are truly independent of the executives. However, for several reasons, there is widespread doubt regarding their independence in practice. It is believed that many NEDs are selected on the basis that they will fit in with the executives' ideologies and that, even when NEDs are nominated by a nomination committee, the CEO will play a significant 'behind the scenes' role.
4. There is a general belief that NEDs lack the motivation to stringently monitor the executives.

• The result of these weaknesses is that, despite efforts (such as the Higgs Report) to improve the effectiveness of NEDs, there is a general feeling that NEDs do not in general provide significant improvements to corporate governance.

Chapter 8

Essay question

• This question requires you to discuss how the **CA 2006** has reformed the law relating to share capital and capital maintenance. It is important to remember that sometimes you will not only need to know what the law is, but also what it was, so that you can compare the two.

• You may want to begin by giving a brief overview of the rules relating to capital maintenance, noting in particular the aims behind these rules, notably to protect the company's creditors by preventing capital from being returned to the shareholders.

• Before going on to discuss the 2006 reforms, it is also worth pointing out that the pre-2006 law was widely regarded as being overly technical and complex, anachronistic, and ineffective.

• There is little doubt that the 2006 Act has introduced a number of reforms that have improved the law in this area and you should discuss the benefits of these reforms. Beneficial reforms would include:

1. The abolition of the concept of authorized share capital. As discussed on p 117, 'Authorized share capital', the requirement was largely pointless and simply served to inconvenience companies.
2. Allowing private companies to reduce share capital without the need to obtain court approval. Prior to the 2006 Act, in order to reduce capital, all companies needed to obtain court approval. Court approval was a major burden for private companies, especially given that, for many smaller companies, the capital maintenance rules are of little practical relevance.
3. Abolishing the prohibition on providing financial assistance for the purchase of shares in relation to private companies. The prohibition served to prohibit transactions that were innocuous and commercially

beneficial.

• Despite this, however, there are still problems that the 2006 Act has failed to remedy. Such problems would include:

1. The 2006 Act has done little to prevent companies allotting shares at a discount. As noted at p 121, ‘Prohibition on allotting shares at a discount’, the rules contained in the **CA 1985** were somewhat lax in relation to private companies and the **CA 2006** has done nothing to strengthen these rules.

2. As discussed at p 123, ‘Minimum capital requirement’, the minimum capital requirements imposed on public companies are universally regarded as weak and the 2006 Act has not strengthened them in any way.

3. Although the prohibition on providing financial assistance has been abolished in relation to private companies, it remains for public companies. However, a convincing rationale for the prohibition has never been fully articulated by the courts and many believe that the prohibition should be abolished completely (although it is acknowledged that, currently, this is impossible as the prohibition is a requirement of the **Second EC Company Law Directive**).

• The conclusion that will likely be drawn is that the statement is an accurate one. The 2006 Act has improved the law, but not in all respects and several notable weaknesses remain.

(p. a10) Chapter 9

Essay question

The rule in *Foss v Harbottle*

• Briefly explain the three principles that form the Rule in ***Foss v Harbottle*** (hereinafter referred to as the Rule). However, the Rule cannot be absolute. Were it so, wrongs committed by the directors or the majority shareholders would rarely be subject to litigation. Accordingly, in limited situations, the courts would allow members to bring actions on a company’s behalf (the ‘derivative action’).

• While the existence of, and justifications behind, the Rule itself are not open to significant criticism, there is little doubt that the operation of the Rule and its exceptions came in for significant criticism. The Law Commission identified four major problems:

1. The Rule and its exceptions are a creation of case law, much of which was created many years ago.

2. A member who wished to bring an action to recover damages where the company suffered loss due to a breach of the directors’ fiduciary duties would need to establish that the wrongdoers had control of the company. However, what constituted ‘control’ was not clear.

3. A member who wished to bring an action to recover damages where the company suffered loss due to the negligence of a director would need to show that the negligence conferred a benefit on the controlling shareholders (***Pavlides v Jensen* [1956]**), or that the failure of the other directors to bring an action constituted a fraud on the minority.

4. A member who wished to bring a derivative action will need to establish standing by showing that he has a *prima facie* case. The potential exists for these standing hearings to become mini-trials which further increased the already high cost of litigation.

• Accordingly, the Law Commission, along with a number of respondents to the consultation paper and the Company Law Review Steering Group, recommended that a new derivative action be created. The result was the creation of the ‘statutory derivative claim’, the details of which can be found in **Pt 11 of the Companies Act 2006**.

The statutory derivative claim

• **Part 11** of the 2006 Act does not abolish the Rule in ***Foss v Harbottle*** and the Rule itself and its justifications retain much of their force. However, the common law derivative action has been abolished and a member can only bring an action on behalf of the company in accordance with the rules relating to the new statutory derivative claim.

• Discuss the operation of the statutory derivative claim, focusing in particular on the differences that exist between the common law derivative action and the statutory derivative claim. Notable differences include:

> **1.** The rules relating to the derivative action can be found in a mass of common law, which adversely affected the accessibility and clarity of derivative actions. Having a statutory derivative claim will better alert members, directors, and other interested parties to the existence of the remedy. The disadvantage of placing the remedy in statute is that alteration of the remedy will require amending the 2006 Act, and amending legislation is rarely a quick and simple process.
>
> **2.** Under the common law, negligence could only form the basis of a derivative action if the wrongdoer gained some form of benefit from the negligent act. This limitation has not been preserved in the 2006 Act and derivative claims can be brought for any negligent act. This reform has caused fears that derivative claims will increase sharply.
>
> **3.** A common law derivative action could be based on an act/omission by a director or a member. A statutory derivative claim can only be based on the acts/omissions of a director (including former directors and shadow directors).
>
> **4.** Permission from the court was required to continue a derivative action, and this requirement is preserved for derivative claims. However, the 2006 Act provides guidance on what factors are relevant when determining whether or not to grant permission. Such guidance did not exist under the common law. To date, few cases **(p. a11)** have been granted permission to continue—be prepared to discuss these cases and their impact.

• One final point is worth noting. With the creation of the unfair prejudice remedy, derivative actions/claims are much less common and it could be argued that the shareholder remedy is of little significance in practice.

Chapter 10

Essay question

• Prior to the enactment of the **Insolvency Act 1985**, UK company law did little to aid ailing companies and companies that struggled with financial difficulties were ‘left to die’. Highlight the severe consequences that can result from the liquidation of a company.

• Point out that the law needs to strike a delicate balance between aiding struggling companies and protecting the creditors of such companies. Should a rescue attempt fail and the assets of the company be depleted further, the creditors will receive even less than if the rescue attempt had not been made.

• The 1982 Cork Report favoured the UK adopting a ‘rescue culture’ whereby mechanisms are put in place to aid struggling companies. The result was the introduction of two notable rescue procedures, namely administration and company voluntary arrangements.

Administration

• Administration was introduced by the **Insolvency Act 1986** and is a clear example of the law’s desire to foster a rescue culture and aid ailing companies. In recent years, the value of the administration procedure has been in evidence. In January 2009, the UK entered recession and a number of prominent high-street companies experienced severe financial difficulties and went into administration in an effort to avoid liquidation. In adverse economic times, the value of the administration procedure is greater than ever.

• The pro-rescue nature of the administration process is evident from the hierarchy of objectives that an administrator is appointed to achieve. Discuss the three hierarchical objectives of administration, making sure to

note that rescuing the company as a going concern is the first objective.

• The pro-rescue nature of the administration process is further evidenced by the statutory moratorium. Discuss the rationale behind the imposition of the moratorium.

• Discuss the advantages that a rescue procedure like administration can have over placing the company in liquidation, including:

1. It may allow a company to trade its way back into profitability.

2. Administration is likely to be less expensive than liquidation.

3. Upon liquidation, the company's assets are usually sold off for whatever price the liquidator can obtain, whereas assets sold by an administrator are likely to fetch a higher price.

4. The company's creditors may have better prospects of being paid than if the company were liquidated, and the employees (or some of them) may be able to retain their jobs.

Company voluntary arrangements

• Point out that the CVA is an important, but much underused, rescue procedure. Explain the basic workings of a CVA.

• The pro-rescue nature of the CVA is evidenced in that, if the company is in the process of being wound up when the CVA is approved, then the court can stay the winding-up and give such directions as it thinks appropriate for facilitating the implementation of the CVA.

• Initially, the effectiveness of CVAs was adversely affected by creditors who could derail the CVA by appointing a receiver or by petitioning the court for a winding-up order. Accordingly, a new form of CVA was introduced that provides the company with a moratorium similar to that which exists under the administration procedure.

• Point out that whilst a CVA is a useful rescue procedure, there is little doubt that administration is a more effective procedure. Discuss why administration is preferable to a CVA, but also state that, for directors who wish to retain office, a CVA might be a more appropriate procedure.

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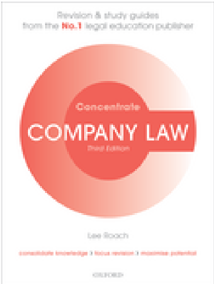

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Glossary

agent
A person engaged to act on behalf of another person (that other person being known as the principal).

articles of association
The principal constitutional document of a company that usually provides for rules that regulate the internal affairs of the company.

authorized share capital
The maximum total nominal value of shares that may be allotted by a company.

bonus shares
Shares allotted to existing shareholders and paid for out of the company's distributable profits.

book debt
A sum owed to a company by those who have purchased goods or services from the company.

called-up share capital
Where a company calls for payment on shares that have not been fully paid for, the amount called for plus the paid-up share capital is known as the called-up share capital.

capacity
The ability of a person to enter into certain transactions or make certain decisions. For example, a company's contractual capacity refers to its ability to enter into legally binding contracts.

capital maintenance regime
A series of rules designed to protect creditors by maintaining a company's level of capital by preventing capital from being returned to the company's members.

charge
Any form of security where possession of property is not transferred.

chargee
A creditor who obtains a charge from another person.

chargor
A debtor who grants a charge to another person. Also known as the ‘surety’.

class rights
The rights that are attached to different classes of shares.

codification
The process whereby law is collected and restated in statute.

Companies House
An executive agency of the government responsible for incorporating and dissolving companies, and for storing information relating to companies that can be inspected by the public.

company secretary
An officer and agent of the company who is usually responsible for ensuring that the company complies with its legal and financial obligations.

corporate member
A company member who is a body corporate (e.g. a company or LLP).

corporate personality
The separate personality that belongs to legal persons (e.g. companies, LLPs). Also known as separate !personality or legal personality.

crystallization
The process whereby a floating charge fixes onto the charged assets.

debenture
A document whereby a company creates or acknowledges a debt, whether unsecured or secured.

debt capital
The capital that companies obtain through borrowing from others. Also known as ‘loan capital’.

de facto
‘In fact’.

default
A general term used in many pieces of legislation that refers to a failure to perform a legally obligated act (e.g. to appear in court when required).

de jure
‘In law’.

dividend
The distribution, usually in cash, of profits to the members, usually at a fixed amount per share.

fiduciary
The word ‘fiduciary’ can refer to:

> **(i)** a relationship of trust and confidence (for example, solicitor and client, doctor and patient, or trustee and beneficiary), or
>
> **(ii)** a person who is in such a relationship and who is under an obligation to act in the other’s interests (for example, a doctor, solicitor, or trustee).

golden parachute
An agreement between a company and an employee (usually an executive director) providing that the employee will receive certain benefits upon the termination of his employment.

(p. a13) identification theory
A theory which states that the knowledge of certain persons is to be attributed to the company.

incorporation
The process by which a company or LLP is created.

initial public offering
(IPO) The first sale of shares by a company to the public at large.

insolvency
A company is deemed to be insolvent if it is unable to pay its debts as they fall due.

issued share capital
The total nominal value of shares that a company has actually issued.

joint and several liability
Persons who are jointly and severally liable may be sued jointly for a loss, or any one person can be sued for the entire loss (although that one party can usually obtain a contribution from the other liable parties).

limited liability partnership
A business structure established by the Limited Liability Partnerships Act 2000.

listed company
A public company whose shares are listed on a stock exchange.

memorandum of association
Historically, the principal constitutional document which regulated the external affairs of a company. Its importance has diminished significantly following the passing of the CA 2006. It now merely provides basic information concerning a company at the time of its creation.

misfeasance
The improper or unlawful performance of a lawful act. Can be contrasted with malfeasance, which is the performance of an unlawful act.

nominal value
A fixed value attached to shares when they are allotted, which may bear no resemblance to the actual value of the shares.

novation
The act of substituting one contract for another.

objects clause
A clause in a company's constitution setting out the objects or purposes for which the company was set up.

ordinary resolution
A resolution passed by a simple majority (i.e. over 50 per cent).

ordinary shares
Where a company only has one class of share, its shares will be known as ordinary shares, which will entitle the holder to the normal rights of share ownership (e.g. to vote at general meetings).

paid-up share capital
The combined nominal value of share capital that has actually been paid.

parent company
A company is a parent company of another company if it:

(i) holds the majority of voting rights in the other company, or

(ii) is a member of the other company and has the right to remove or appoint the board of directors, or

(iii) is a member of the other company and controls alone, pursuant to an agreement with other members, a majority of the voting rights in it.

pari passu
'With equal step'.

partnership
A business structure defined by s 1(1) of the Partnership Act 1890 as 'the relation which subsists between persons carrying on a business in common with a view to profit'.

pre-emption right
The right of first refusal belonging to existing shareholders upon the allotment of a new batch of shares. The company must first offer the shares to the existing shareholders.

preference share
Shares which entitle the holder to some sort of benefit or enhanced right, usually in relation to the entitlement to a dividend.

promoter
A person who undertakes and enters into the process of setting up of a company.

proxy
A person appointed to vote or act on behalf of another for another (e.g. at a general meeting of a company).

qua
'In the capacity of'.

quorum
The minimum number of persons required to have a formal meeting. Meetings lacking a quorum are said to be 'inquorate'.

quoted company
A company whose shares are listed on the UK official list, or in an EEA state, or on the New York Stock Exchange or Nasdaq.

(p. a14) redeemable shares
Shares issued by a company which can be redeemed (bought back) by that company should the company or the member so require, or upon the passing of a stated period.

registered company
A company created through incorporation by registration.

Registrar of Companies
The Chief Executive of Companies House. The principal functions of the Registrar are to register the incorporation and dissolution of companies, and to ensure that documents delivered to Companies House are accurate.

resolution
A decision arrived at by a formal vote.

share
A measure of a person's interest in a company. The owner of a share is called a shareholder.

share capital
The capital that the company acquires through the selling of shares. Also known as equity capital.

share premium
The sum paid for a share in excess of the share's nominal value, which usually represents the difference between the nominal value of the share and its market value.

sole practitioner
A sole proprietor who is a professional (e.g. solicitor, accountant).

sole proprietorship
A business structure consisting of an individual who conducts business on his own account, and who bears the risk of business failure and is also entitled to the profits of the business.

sole trader
A sole proprietor who is not a professional.

special resolution
A resolution passed by a majority of not less than 75 per cent.

subsidiary
A company is a subsidiary company of another company if that other company:

- **(i)** holds the majority of voting rights in it, or
- **(ii)** is a member of it and has the right to remove or appoint the board of directors, or

(iii) is a member of it and controls alone, pursuant to an agreement with other members, a majority of the voting rights in it.

substratum
The purpose(s) for which a company is formed.

thing
An item of property other than land.

thing in action
An intangible thing which, being intangible, can only be claimed or enforced by legal action, as opposed to by taking possession of it (e.g. a share).

ultra vires
'Beyond one's powers'. If a company acts outside the scope of its constitution, it will be acting *ultra vires*.

uncalled share capital
The difference between the company's issued share capital and its called-up share capital.

unissued share capital
The difference between a company's authorized share capital and its issued share capital.

unregistered company
A company not incorporated by registration (i.e. one created through incorporation by Act of Parliament or through incorporation by Royal Charter).

Law Trove

Company Law Concentrate: Law Revision and Study Guide (3rd edn)

Lee Roach

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